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Status: GRANTED

Title: Harold T. Paulsen, et ux., Petitioners
v.
Commissioner of Internal Revenue

Docketed:
November 14, 1983

Court: United States Court of Appeals
for the Ninth Circuit

Counsel for petitioner: Bryar, Karen Smith

Counsel for respondent: Solicitor General

ntry	Date	Note	Proceedings and Orders
1	Nov 14 1983	G	Petition for writ of certiorari filed.
3	Dec 21 1983		Order extending time to file response to petition until January 10, 1984.
4	Jan 10 1984		Order further extending time to file response to petition until January 17, 1984.
5	Jan 18 1984		Brief of respondent CIR in opposition filed.
6	Jan 18 1984		Brief amicus curiae of California League of Savings Institutions filed.
7	Jan 25 1984		DISTRIBUTED. February 17, 1984
8	Feb 21 1984		Petition GRANTED.
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10	Mar 19 1984		Order extending time to file brief of petitioner on the merits until April 25, 1984.
11	Apr 9 1984		Order further extending time to file brief of petitioner on the merits until May 9, 1984.
12	May 11 1984		Brief of petitioners Harold T. Paulsen, et ux. filed.
13	May 12 1984		Brief amicus curiae of California League of Savings filed.
14	May 16 1984		Joint appendix filed.
16	Jun 14 1984		Order extending time to file brief of respondent on the merits until July 13, 1984.
17	Jun 18 1984		Record filed.
18	Jul 16 1984		Order further extending time to file brief of respondent on the merits until July 27, 1984.
19	Jul 27 1984		Brief of respondent CIR filed.
20	Aug 21 1984		CIRCULATED.
21	Aug 28 1984		SET FOR ARGUMENT. Monday, October 29, 1984. (3rd case)
22	Oct 19 1984	X	Reply brief of petitioners Harold T. Paulsen, et ux. filed.
23	Oct 29 1984		ARGUED.

No. 83-832

IN THE

Supreme Court of the United States

October Term, 1983

HAROLD T. and MARIE B. PAULSEN,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

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Question Presented for Review.

Whether a shareholder's exchange of shares in a stock-type savings and loan association for ownership savings accounts in a Federal mutual savings and loan association as part of a merger of the two institutions was a tax-free exchange in pursuance of a plan of reorganization within the meaning of Sections 368(a)(1)(A) and 354(a)(1) of the Internal Revenue Code.

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IN THE

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COMMISSIONER OF INTERNAL REVENUE,

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

Harold T. and Marie B. Paulsen, Petitioners herein, pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in this case.

Opinions Below.

The opinion of the Ninth Circuit is not yet reported and is set forth in its entirety in the Appendix hereto at 20-32. The opinion of the Tax Court, reversed by the Ninth Circuit, is reported as *Paulsen v. Commissioner*, 78 T.C. 291, Tax Ct. Rep. (CCH) Dec. 38,825, at 2807 (1982). It is set forth in the Appendix at 1-18.

Grounds for Jurisdiction.

The decision below was issued by the Ninth Circuit on August 16, 1983 and judgment was entered on that date. Petitioners did not file a petition for rehearing in the Ninth

Circuit. In accordance with 28 U.S.C. § 2101(c), this petition was filed within ninety days of the date judgment was entered. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Statutes Involved.

The relevant portions of Sections 354, 368 and 7701 of the Internal Revenue Code of 1954, as amended, 26 U.S.C. (the "Code"), and of 12 C.F.R. § 544.1(b), as in effect on July 1, 1976, are set forth in the Appendix at 34-35.

Statement of the Case.

On July 1, 1976, Commerce Savings and Loan Association of Tacoma ("Commerce"), merged into Citizens Federal Savings and Loan Association ("Citizens Federal"). Prior to the merger, Commerce was a state-chartered stock-type savings and loan association. It was owned by the shareholders of its guaranty stock. Citizens Federal is a federally chartered mutual savings and loan association. It is owned solely by its account holders whose accounts represent shares in the association.

Pursuant to a Plan for Merger, the petitioners, Harold and Marie Paulsen, exchanged their Commerce guaranty stock for Citizens Federal savings accounts which had a value in excess of their basis in the Commerce stock. On audit of the petitioners' 1976 Federal income tax return, the Commissioner asserted a deficiency based on his determination that petitioners were required to recognize gain in 1976 in an amount measured by the difference between the petitioners' adjusted basis in the Commerce guaranty stock they gave up and the face value of the Citizens Federal accounts they received in the merger.

The Commissioner issued a statutory notice of deficiency, and the Paulsens petitioned the United States Tax Court for

redetermination of the asserted deficiency. They contended that the merger was a reorganization of the two savings and loan associations within the meaning of Section 368 of the Code and that recognition of any gain on the exchange was therefore deferred by Section 354(a)(1) until such time as the petitioners withdrew or otherwise disposed of the Citizens Federal accounts they received in the transaction.

Section 354(a)(1) of the Code, on which the petitioners relied, provides that no gain or loss is recognized on an exchange of stock in a corporation that is a party to a reorganization for stock in the same or another corporation also a party to the reorganization if the exchange is in pursuance of the plan of reorganization. "Stock" in a "corporation" is defined by Section 7701 to include "shares in an association," and Section 368(a)(1)(A) of the Code includes "a statutory merger or consolidation" within the class of corporate transactions constituting a reorganization. I.R.C. § 7701(a)(3), (7) & (8).

The Tax Court, in an opinion by Judge Featherston, agreed with the petitioners' analysis of their transaction. It held that the exchange of guaranty stock for savings accounts pursuant to the terms of the merger did not trigger recognition of any gain under the Code. The Tax Court concluded that the accounts received by the petitioners and the other guaranty stockholders of Commerce provided them with the continuity of proprietary interest in the modified enterprise that is required under the case law and therefore constituted "stock" for purposes of the reorganization provisions of the Code. The court accordingly found that the merger was a "reorganization" exempt from taxation under Section 368(a)(1)(A) of the Code and that the petitioners had not recognized any gain because Section 354(a)(1) applied to their exchange. A decision was entered in the petitioners' favor on March 8, 1982. *Paulsen v. Commissioner*, 78 T.C.

291, 302-03, Tax Ct. Rep. (CCH) Dec. 38,825, at 2807 (Mar. 8, 1982).

The Commissioner appealed the Tax Court decision to the Court of Appeals for the Ninth Circuit. In an opinion written by Judge Norris with Judges Hug and Poole concurring, the Ninth Circuit reversed the Tax Court. *Paulsen v. Commissioner*, Slip Op. (August 10, 1983), set forth in the Appendix hereto at 20-32. The Court of Appeals concluded that a merger of a stock-type savings and loan association into a mutual savings and loan association does not constitute a reorganization exempt from recognition of gain or loss under the Code.

The parties filed a joint stipulation of facts in the Tax Court. Thus, as the Ninth Circuit found, "[t]he material facts are not in dispute." Slip Op. at 2. Both the Tax Court and the Court of Appeals agreed that the pertinent facts, which relate to the corporate structure of Commerce and Citizens Federal and to the consequences of the merger between the two entities, are as follows.

Commerce was a stock-type savings and loan association chartered by the State of Washington. Pursuant to its state charter, Commerce was authorized to issue guaranty stock, to offer various classes of non-ownership savings accounts, and to make loans. Each holder of a savings account or guaranty stock and each borrower was denominated a "member" of Commerce. With regard to matters requiring the approval of Commerce's members, holders of guaranty stock were entitled to one vote per share, holders of savings accounts to one vote per $100 on deposit, and borrowers to one vote each. The guaranty stockholders owned all the equity interest in Commerce. Holders of Commerce savings accounts held no interest in and had no liquidation rights in the net assets of the association.

Citizens Federal is a federally chartered mutual savings and loan association and, as a mutual institution, does not issue standard capital stock. Its charter, Charter K (Rev.), only permits it "[t]o raise its capital . . . *by accepting payments on savings accounts representing share interests in the association*." Charter K (Rev.) ¶ 3(6); 12 C.F.R. § 544.1(b) (as in effect on July 1, 1976) (emphasis added). Citizens Federal's account holders therefore hold all the proprietary rights and interest in the association and are the sole owners of its assets.

On matters which require approval from the members of the association, each holder of a savings account is entitled to one vote for every $100 (or fraction thereof) of the amount invested in his account, up to a maximum of 400 votes. A borrower from Citizens Federal is regarded as a non-proprietary member and is accorded one vote. Except for this one vote accorded each borrower, the account holders have the full voting power, and thus the ultimate control over the association. The account holders elect the Board of Directors, receive full annual financial reports on the association, can amend its charter and bylaws, and have the right to approve major changes of policy and organization. Only members of the association are eligible to become or remain directors.

Citizens Federal's charter and bylaws provide that twice each year its net earnings and any surplus are to be distributed to account holders on a pro rata basis. Account holders receive dividends which are expressly dependent upon the financial success of the association. Charter K (Rev.) ¶ 10. Distributions on accounts are made only out of profits of the enterprise, ratably according to the size of the investment. The amount of the distribution, if any, is determined and declared periodically by the Board of Directors. Charter K (Rev.) ¶ 10. If the association is not profitable or its

reserves in surplus are too low, no distribution will be made on any account, and the association is liable for none. Charter K (Rev.) ¶ 10.

In the event of the liquidation or dissolution of Citizens Federal, savings account holders are entitled to a pro rata distribution of its assets. Under the terms of its charter, Citizens Federal will also honor requests to withdraw by its savings account holders within thirty days, so long as funds are available to honor the redemption requests without jeopardizing the financial well-being of the institution.

On July 1, 1976, Commerce was merged into Citizens Federal. Under the Plan for Merger, shareholders of Commerce were to exhange their guaranty shares for savings accounts representing share interests in Citizens Federal. Each guaranty share of Commerce was exchanged for a $12 account in Citizens Federal, subject to the restriction that no account received in the exchange could be withdrawn for at least one year. Participants in the exchange were also given the right, in the merger agreement, to borrow money from Citizens Federal against the security of their accounts at a slightly lower interest rate (0.5% less) than that normally charged account holders for similar loans.

Petitioner Harold Paulsen was a director and the president of Commerce. Before the merger, Harold Paulsen and his wife owned 17,459 shares of Commerce guaranty stock with a cost basis of $56,802. Pursuant to the terms of the Plan for Merger, the Paulsens exchanged their guaranty stock for passbook and term savings accounts with a total face value of $209,508.

On appeal, the Ninth Circuit accepted the Government's argument that "the predominant characteristics" of the accounts received by the petitioners in the exchange "are those of debt rather than those of equity, and that, in reality, the

shareholders simply sold their guaranty shares for the equivalent of cash." Slip Op. at 1-2. The Court of Appeals concluded that the petitioners had received a debt interest in the merged corporation even though the Commissioner conceded that the accounts issued to the petitioners conferred "the right to vote, the right to share in the profits of the association, and the right to share in liquidation proceeds." Brief for the Appellant on Appeal from the Decision of the United States Tax Court in *Paulsen v. Commissioner*, at 8. The Ninth Circuit opinion also recognized that the "only owners" of Citizens are its account holders, but the court concluded that the "owners" were nothing more than "creditors" (Slip Op. at 12, 14), and decided that the merger should be treated as a sale rather than a reorganization within the meaning of the code.

The petitioners now seek review of the Ninth Circuit's decision and judgment on the application of the reorganization provisions of the Code to the merger of Commerce and Citizens Federal and to them as participants in that merger.

REASONS FOR GRANTING THE PETITION FOR A WRIT OF CERTIORARI.

This Court should grant a petition for certiorari. The decision of the Ninth Circuit directly conflicts with three other decisions on the same issue rendered by three different courts of appeals. The reasoning of the Ninth Circuit is also in conflict with the standards governing tax-free reorganizations established in a series of decisions by this Court. Finally, the proper interpretation of these sections represents an important issue of federal law which must be resolved.

I.

The Decision Below Is in Direct Conflict With Decisions Rendered by the Sixth Circuit, the Tenth Circuit, and the Court of Claims on the Same Issue.

In reversing the Tax Court's holding that the merger between Commerce and Citizens Federal was a tax-free reorganization, the Ninth Circuit stated that, "*[w]e recognize that our decision conflicts with that reached by several other courts.*" Slip Op. at 15 (emphasis added). The Ninth Circuit acknowledged that the Courts of Appeals for the Sixth Circuit and the Tenth Circuit and the Court of Claims have all held that mergers "similar to that here" of a stock savings and loan association into a mutual savings and loan association are tax-free reorganizations because the savings accounts in a mutual association are "stock" within the meaning of the Code. Slip Op. at 15. *See Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971). The Ninth Circuit nevertheless found that, "[w]e are neither bound nor persuaded by those authorities." Slip Op. at 16.

The direct conflict between the result reached by the Ninth Circuit in this case and the previous decisions of the Court of Claims and Courts of Appeals for the Sixth and Tenth Circuits was also acknowledged by the Tax Court and the Commissioner. The Tax Court declined independently to reexamine the question presented in this case, noting that the issue was not one of "first impression." 78 T.C. at 302-03. It concluded that the decisions in *Capital Savings*, *West Side Federal Savings*, and *Everett* should not be reevaluated because they represented a "long outstanding and unbroken line of holdings . . . that savings accounts in a mutual savings and loan association qualify as 'stock'. . . ." 78 T.C. at 303.

Similarly, the Commissioner did not even attempt to persuade the Ninth Circuit that the above three decisions were consistent with the interpretation of the Code he advanced. Instead, he took the position that those opinions "were wrongly decided" and argued, "[t]hat other courts may have reached erroneous non-tenable conclusions . . . should in no way constrain [the Ninth Circuit] to do the same." Brief for the Appellant on Appeal from the Decision of the United States Tax Court in *Paulsen v. Commissioner, supra*, at 23, 26. A review of the opinions issued by those courts readily reveals why the Commissioner, the Tax Court and the Ninth Circuit made no effort whatsoever to distinguish the facts or legal issues they presented from those presented in this case.

In *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979), the court held that the statutory merger of Franklin, a state guaranty stock-type association into Capital, a mutual association whose capital consisted solely of voting ownership accounts, qualified as a reorganization under Section 368(a)(1)(A) of the Code. *Id.* at 971-72. The Government had contended that the receipt by

Franklin guaranty stockholders of the Capital savings accounts should be characterized as a sale rather than as a "reorganization" on the basis of the same theory asserted by the Commissioner in the Ninth Circuit: the mutual savings and loan association accounts received by the former guaranty stockholders were predominantly debt rather than "stock" and therefore did not transfer a sufficient proprietary interest to the account holders to warrant characterization of the transaction as a reorganization rather than a sale. *Id.* at 974; Brief for the United States in Support of its Motion for Summary Judgment in *Capital Savings & Loan Association v. United States*, Ct. Cl. No. 552-76 (Oct. 17, 1979), at 11.

The Court of Claims rejected the Government's theory that the accounts did not represent a continuation of a proprietary interest in the reorganized entity:

> As the law assumes that someone must own an association or corporation, we joint the courts in *West Side, supra*, and *Everett, supra*, in refusing to reach a decision which illogically implies that . . . [a mutual savings and loan association] is without owners and which may unduly hinder otherwise desirable reorganizations. Though savings accounts are easily converted into cash, as long as the account remains unliquidated, its holders continue their equity investment in the association in the form of share accounts.

607 F.2d at 976 (footnote omitted).

Both the *Capital* decision and the Tax Court's decision below were solidly grounded in precedent. Eight years before *Capital*, shortly after the Commissioner began his efforts to refuse tax-free reorganization status to transactions in which mutual savings and loan associations used their accounts to acquire guaranty stock associations, the Court of Appeals for the Tenth Circuit had held that such accounts

constituted "voting stock" of an acquiring federal mutual savings and loan association within the meaning of Section 368(a)(1)(C) and (2)(B) of the Code. *Everett v. United States*, 448 F.2d 357, 359-60 (10th Cir. 1971). In so holding, the Tenth Circuit rejected the argument advanced by the Commissioner that "such interest more nearly represents that of a creditor than a true proprietary interest and hence cannot be said to constitute 'solely voting stock'." *Id.* at 359.

Following *Everett*, in a case which the Tax Court characterized as "identical" to this case "in all material respects," the Court of Appeals for the Sixth Circuit held that the merger of a state stock-type savings and loan association into a federal mutual association qualified as a tax-free reorganization within the meaning of Section 368(a)(1)(A). *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404, 405, 411 (6th Cir. 1974). There again, the Commissioner had asserted that a federal mutual account holder's equity interest "was minimal compared to his rights as a creditor" and argued that the conversion of the state association's stock into voting membership accounts in the federal mutual association pursuant to the merger was in essence an exchange of stock for "cash or its equivalent." *Id.* at 406, 409, 411. Once again, the contention was rejected. *Id.* at 411.

Relying on the applicable decisions of this Court, the Sixth Circuit found that "there is no requirement that the relationship of the transferor or its shareholders to the assets transferred remain unchanged. The interest which the transferor or its shareholders acquire must be at least in substantial part a proprietary or equity interest," but the holdings of the Supreme Court do not direct the courts to "conduct an examination to determine whether the shareholder of the merged corporation receives more or less of a proprietary interest than he surrendered." 494 F.2d at 409, 411. For

this reason "it is improper to ignore the proprietary rights" conferred by share accounts in a mutual association simply because the proprietary rights in a stock association may have been greater. The court accordingly held that the exchange of guaranty stock for membership accounts constituted a "reorganization" under the Code. In stark contrast, the Ninth Circuit has held in this case that the exchange of the identical ownership interests did *not* constitute a "reorganization," reasoning that "[t]he critical question . . . is whether the position of the shareholders in the reorganized entity has really changed," and concluding that the exchange in question "converted a risky investment into a risk-free one and a highly illiquid position into a highly liquid one." Slip Op. at 14.

The interpretive conflict created by the Ninth Circuit opinion in this case should be resolved by this Court. First, the conflict between the Ninth Circuit opinion and that of the other appellate decisions and the Court of Claims is direct: the Court of Claims, the Sixth Circuit and the Tenth Circuit have held that accounts in a federal mutual savings and loan association *are* "*stock*" and that, accordingly, a merger of a stock-type savings and loan association into a mutual savings and loan association *is a tax-free reorganization* within the meaning of the Code; conversely, the Ninth Circuit held that such accounts are *not* "*stock*," so that the merger of a stock-type savings and loan association into a mutual savings and loan association *is not a tax-free reorganization* under the Code.[1]

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[1]The only difference between these cases is that the taxpayer in the three prior cases was the corporation, rather than the shareholder. The same statutory provisions are in issue, however. As the Government has repeatedly acknowledged, the characterization of a merger such as this as a reorganization does not depend upon who is the taxpayer. If the transaction qualifies as a reorganization for the associations involved, it necessarily follows that it is a tax-free reorganization exchange for the former guaranty stockholders of the acquired association. The Government in fact has acknowledged that it would be "plain nonsense" to reach any other result. Reply Brief for the United States in Support of its Motion for Summary Judgment in *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979), at 10 n. 4. For this reason, the Ninth Circuit and the Commissioner do not rely upon this difference in the identity of the taxpayer. It is immaterial to the issue of statutory interpretation presented.

Second, it cannot be expected that uniformity will be restored to this area of the law without resolution of the issue by this Court. The three decisions in conflict with the Ninth Circuit opinion are recent and thoroughly reasoned. Further, the Ninth Circuit did not rely upon any statutory or judicial developments subsequent to the issuance of the prior decisions which would be likely to change the outcome reached by those courts. Thus, the conflict can be expected to persist even after other lower federal courts have an opportunity to consider the opinion of the Ninth Circuit.

Third, this case presents an excellent opportunity for the resolution of the conflict. There are no factual disputes. There are no material factual differences between the merger in issue and the typical merger of a stock-type savings and loan association into a mutual savings and loan association. There are no other issues involved which could support the judgment of the Ninth Circuit. Thus, nothing would prevent this Court from reaching and resolving the conflict.

Finally, as set forth more fully below, the issue raised is a recurring one. This is therefore not a conflict which this Court should decline to resolve on the ground that the issue is unlikely to reappear in the future. The lower federal courts have addressed the issue on a number of occasions, they have now reached conflicting opinions, and uniformity will not be restored until this Court resolves the dispute.

II.

The Decision Below Is Contrary to Decisions of This Court.

The decision of the Ninth Circuit is in conflict with this Court's interpretation of the Code provisions governing tax-free reorganizations and the nature of an account holders' legal interest in a mutual savings and loan association.

First, the Ninth Circuit held that a business transaction unquestionably encompassed by the literal language of the Code nevertheless failed to qualify as a "reorganization" even though this Court has directed that Congress intended an expansive interpretation of these sections.

Section 368 of the Code, which sets forth the types of corporate transactions that constitute a "reorganization," includes within the meaning of that term "a statutory merger or consolidation." I.R.C. § 368(a)(1)(A). In conjunction with Section 368, Section 354 provides that

> [n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

I.R.C. § 354. Congress defined the term "corporation" in the Code to include an association, the term "stock" to include "shares in an association" and the term "shareholder" to include a "member in an association." I.R.C. §§ 7701(a)(3), (7) & (8).

By their express terms, these Code sections apply to the transaction at issue in this case. The taxpayers exchanged stock for "shares in an association" in "pursuance of the plan of reorganization." A literal reading of Section 354 would therefore exempt the petitioners' exchange, but the Ninth Circuit declined to allow the words chosen by Congress to govern.

The Ninth Circuit's reluctance to implement the terms used by Congress is inconsistent with this Court's direction in *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). In *Pinellas*, the Court had its first opportunity to construe which transactions Congress intended to exempt from taxation under the predecessor to Section 368 of the Code. Although it found that the transaction at issue there was a sale of assets for short term notes and therefore not a reorganization, the Court expressly rejected the lower court's restrictive interpretation of the language included in the statutory provisions, noting that Congress intended to "expand the meaning of 'merger' or 'consolidation' " to confer tax exempt status even to some transactions "beyond the ordinary and commonly accepted meaning" of the terms. *Id.* at 470. That reading of legislative intent with respect to the reorganization statutes was reaffirmed in 1954 when Congress enacted Sections 368 and 354 of the Code. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 42 (1954) (expressing concern that different types of corporations not be singled out for more restrictive application of the reorganization sections and rejecting portions of a House bill that attempted a "precise" definition of the term "stock"). In deciding that "shares in an association" of savings and loan account holders are more readily viewed as "debt" rather than "stock," the Ninth Circuit denied effect to this Court's conclusion that Congress sought to expand the "commonly accepted meaning" of the terms employed.

Second, the Ninth Circuit held that a transaction which effected a bona-fide restructuring of the business ownership and operations of two savings and loan institutions, after which the same persons remained the owners of the combined entity, did not represent a "reorganization." This

Court, however, has only withheld "reorganization" treatment from those transactions structured as reorganizations in situations where (i) the transferor shareholders do not remain owners of the resulting enterprise or (ii) which have been designated by the taxpayers as "reorganizations" for the sole purpose of tax evasion. That is, the Court has concluded that although Congress intended an expansive interpretation of "reorganization," it did not intend to defer recognition of gain simply because the taxpayer has labeled what is *in fact* nothing other than a "sale" or other profit "distribution" a statutory "reorganization." *See Pinellas v. Commissioner, supra*, 287 U.S. at 468, 470 (acquisition of assets in exchange for cash and short-term notes was a sale and not a reorganization because seller did not "acquire an interest in the affairs of the purchasing company"); *Le Tulle v. Scofield*, 308 U.S. 415, 420-21 (1940) (similarly, for transfer of assets in exchange for cash and bonds); *Bazley v. Commissioner*, 331 U.S. 737, 742-43 (1947) (no reorganization where "nothing was accomplished that would not have been accomplished by an outright debenture dividend").

The instant case does not come within the limited exceptions to reorganization treatment announced by this Court for transactions that literally comply with the statute. Where, as here, the transferor shareholders have continued as owners of the new entity after a merger, the Court has only refused to give effect to the literal meaning of the Congressional language if the transaction was arranged and designated as a "reorganization" by the taxpayer for no "corporate purpose" other than tax avoidance. *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 467, 470 (1935) (holding that the transfer of shares to a shell corporation which never conducted any business and was dissolved in less than a week for the sole purpose of "diminish[ing] the amount of

income tax" was "an operation having no business or corporate purpose" and therefore not a "reorganization" under the statute). It was never alleged in this case that the transaction at issue did not serve all the corporate purposes of a reorganization. The merger was a "bona fide business move" which the "details of corporate affairs" reveal accomplished far more than tax deferral. Under this Court's decisions, such a transaction qualifies as a reorganization exempt from taxation. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

Third, the Ninth Circuit determined that the "critical question" in implementing the statutory scheme is "whether the position of the shareholder in the reorganized entity has really changed" (Slip Op. at 14), even though this Court has repeatedly emphasized that the question is not whether "the relationship of the taxpayer to the assets conveyed was substantially changed," but instead whether the taxpayers received an "interest in the transferee" which is "definite and material." *Helvering v. Minnesota Tea*, 296 U.S. at 385-86 (holding that a reorganization occurred despite a substantial change of position in the interest held by the transferor stockholders); *see John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935) (holding that the receipt by shareholders of the transferor corporation of non-voting callable preferred stock in exchange for their common stock in the acquired corporation gave them a "definite and substantial interest in the affairs of the [acquiring] corporation"). In essence, the Ninth Circuit concluded that because the risk and liquidity of the petitioners' position changed, no reorganization exchange occurred. Slip Op. at 14. Yet this Court has stated that such change is not "inhibited by the statute." 296 U.S. at 386.

The Commissioner's published rulings demonstrate that it is his position, the position now endorsed by the Ninth

Circuit, that the *nature* of the interest received by the petitioners is not controlling, but that it is the *degree of change* in the proprietary interest received that is controlling. For instance, the Commissioner has ruled publicly that accounts in mutual savings and loan associations constitute "stock" if exchanged for other savings accounts (regardless of whether these are proprietary in nature) or for the stock of a guaranty stock-type association; yet these same accounts are *not* "stock" if received in exchange for guaranty stock. *Compare* Rev. Rul. 69-3, 1969-1 C.B. 103 (merger of two mutual savings and loan associations constitutes an "A" reorganization) and Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of a mutual savings and loan association into a guaranty stock-type savings and loan association is a tax-free reorganization) *with* Rev. Rul. 69-6, 1969-1 C.B. 104 (merger of a guaranty stock-type association into a mutual association constitutes a "sale of assets" and not a reorganization within the meaning of Section 368(a)(1)(A)). There can be no doubt, therefore, that the Commissioner seeks to tax a change in the nature of a proprietary interest as precluded by the decisions of this Court.

Finally, the Ninth Circuit held that a share in a mutual savings and loan association is "the equivalent of cash," rather than "stock," even though this Court has held that such shares are "stock" in other statutory schemes. *Tcherepnin v. Knight*, 389 U.S. 332 (1967). The court below characterized the shares received as "debt" and not "stock" despite its conclusion that the account holders were the only "owners" in the reorganized corporation, that the accounts "may be ownership interests for some purposes," and that the "passbook accounts are equity in the sense that they represent the entire capital structure of the association" because, it stated, the shares "are in reality indistinguishable from ordinary cash savings accounts and are essentially the

equivalent of cash." Slip Op. at 12-14.

The Ninth Circuit's construction of the term "stock" is directly at odds with this Court's classification of account holders' interest in a mutual savings and loan association. In *Tcherepnin*, this Court concluded that the equity characteristics and investment risks present in the same type of accounts at issue in this case were sufficient to characterize them as "stock" within the meaning of the Securities and Exchange Act. This Court held:

> *Petitioners are participants in a common enterprise — a money-lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans. Because Illinois law ties the payment of dividends on withdrawable capital shares to an apportionment of profits, the petitioners can expect a return on their investment only if City Savings shows a profit. If City Savings fails to show a profit due to the lack of skill or honesty of its managers, the petitioners will receive no dividends. Similarly, the amount of dividends the petitioners can expect is tied directly to the amount of profits City Savings makes from year to year.* Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) and as defined in *Howey*. But we need not rest our decision on that conclusion alone . . . . *For example, the petitioners' shares can be viewed as "certificate[s] of interest or participation in any profit-sharing agreement." The shares must be evidenced by a certificate, and Illinois law makes the payment of dividends contingent upon an apportionment of profits. These same factors make the shares "stock" under § 3(a)(10).*

389 U.S. at 338-39 (footnotes omitted and emphasis added).

The same characterization of the interest in issue was rendered by the Court of Appeals for the District of Colum-

bia Circuit in an opinion written by then Circuit Judge Burger. *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961). The court there rejected a challenge that new regulations issued by the Federal Home Loan Bank Board unlawfully permitted federal savings and loan associations to accept deposits, and thus act as banks. In his concurring opinion upholding the new regulations, then Circuit Judge Burger, while noting that there are many "superficial similarities" between mutual savings and loan associations and banks, stressed certain material differences between accounts in a federal savings and loan association and deposits in a bank:

> [W]e are *concerned not with appearances but with legal realities*; it is here that the differences are marked as Judge Miller has pointed out. *The capital of a federal savings association is raised by payments on share interests. Calling them "payments" on "savings accounts" does not alter their legal status. That the payment may be regarded by the customer as a "deposit" or even called at times a deposit by the association does not make it a legal counterpart of a deposit in a bank. The "depositor" in a federal association is not a creditor* as is the depositor in a bank . . . . *He is an investor, as the very language of Section 5(b) of the Home Owners Loan Act describes the relationship*. The owner of a "savings account" in the association is entitled to vote, in much the same way as a stockholder in a corporation, to elect the management. The Act under which they exist recites the congressional purpose which emphasizes the "investment" character of these shares and distinguishes them from the creditor-debtor relationship between a bank account depositor and a bank.

294 F.2d at 717-18 (citations omitted and emphasis added).[2]

For the reasons set forth, the opinion of the Ninth Circuit is inconsistent with this Court's interpretation of the same statutory framework.

III.
The Court Below Decided an Important Question of Federal Law Which Needs to Be Settled by This Court.

The importance of a uniform and predictable interpretation of the Code sections governing corporate reorganizations has repeatedly been recognized by this Court, lower federal courts and by the Internal Revenue Service. This Court has thus granted petitions for certiorari raising issues concerning the interpretation of those provisions on at least six occasions. As the Court explained in *Bazley*, "[t]he proper construction of the provisions of the Internal Revenue Code relating to corporate reorganizations" has sufficient "importance to the Treasury as well as to corporate enterprise" to warrant certiorari. *Bazley v. Commissioner*, *supra*, 331 U.S. at 738. Similarly, in its earlier opinion in *Gregory v. Helvering*, the Court specifically noted that the Government had not opposed the taxpayers' petition for certiorari on an issue of "reorganization" interpretation, "considering the question one of importance." 293 U.S. at 468.

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[2]The Commissioner himself consistently took the same position as the courts for many years. *See* Rev. Rul. 54-624, 1954-2 C.B. 16, 17-18 stating:

> [T]he rights possessed by the shareholders of [a federal mutual savings and loan] association are in the nature of proprietary interests which are not at all similar to the rights of a general or special depositor in a bank.

Accord, Rev. Rul. 58-34, 1958-1 C.B. 333, 334 (no debtor-creditor relationship exists between a federal savings and loan association and holders of savings accounts in such association); I.T. 4045, 1951-1 C.B. 34 (account holders are proprietors rather than creditors of the association).

The Tax Court in this case acknowledged the necessity for uniformity in the law on the issue before it when it declined the Commissioner's invitation to reevaluate the soundness of the prior decisions of the Sixth and Tenth Circuits and the Court of Claims. The Tax Court emphasized that "the need for certainty in the law is great because of the high stakes and advanced planning associated with reorganization." 78 T.C. at 303.

The need for certainty and uniformity on the reorganization question presented for review in this case is particularly compelling because of the frequency of savings and loan association mergers. Officials of the Federal Savings and Loan Insurance Corporation advised counsel for the petitioners that 425 mergers of savings and loan associations took place last year. Many of those mergers involved mutual associations. In addition, examination of records available through the Federal Home Loan Bank Board revealed that there have been 11 acquisitions similar to this one in California alone since 1974. In each, the stock of a state association was exchanged for accounts in a mutual association.

The proper tax treatment of every savings and loan association merger and of each shareholder who exchanged guaranty stock for accounts in a surviving mutual association pursuant to such a merger has now been called into question. Litigation of the same issue presented here is therefore sure to follow in numerous cases in the Tax Court and other lower federal courts, as well as the Court of Claims. Indeed, according to an Affidavit filed with the Tax Court in June of 1981 by Edward M. Robbins, Jr., counsel for the respondent in *Owens v. Commissioner*, Docket Nos. 9412-79 and 11711-80, 36 cases arising out of one of the California transactions mentioned above, which took place in 1975, had already been filed at that time. Those cases are now pending before the Tax Court.

Further, as the Court of Claims recognized when it "refuse[d] to reach a decision which illogically implies that . . . [a mutual association] is without owners and which would unduly hinder otherwise desirable reorganizations" (697 F.2d at 976), the uncertainty created by the decision of the Ninth Circuit impacts upon future as well as past mergers. The tax consequences of an exchange of ownership shares must be considered in establishing the values of the interests to be exchanged pursuant to a plan of merger. The ruling of the Ninth Circuit makes such valuations speculative. It also disadvantages a federally chartered mutual savings and loan association competing with a state stock-type association for the acquisition of other associations by creating tax disincentives for mergers with a federal mutual association. The question presented by this case is therefore of great practical importance to corporate planners, to the savings and loan industry, to individual taxpayers and to administrators of the Internal Revenue laws.

Conclusion.

For all the foregoing reasons, the petition for a writ of certiorari should be granted.

Dated: November 14, 1983.

Respectfully submitted,

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APPENDIX.

Opinion of the United States Tax Court.

78 T. C. No. 21.

United States Tax Court.

Harold T. and Marie B. Paulsen, Petitioners *v.* Commissioner of Internal Revenue, Respondent.

Received: March 8, 1982.

Docket No. 17549-79. Filed March 2, 1982.

In 1976, petitioners exchanged "guaranty stock" in a State-chartered savings and loan association for savings accounts in a Federally-chartered mutual (nonstock) savings and loan association pursuant to a plan for the merger of the two associations. The savings accounts carry with them certain proprietary rights such as the right to vote, the right to pro rata distributions of earnings, and the right to share in the distribution of assets upon liquidation.

Held, the savings accounts constitute proprietary interests which satisfy the "continuity of interest" required in a reorganization under sec. 368(a)(1)(A), I.R.C. 1954, and, therefore, petitioners are entitled to treat the exchange of guaranty stock for savings accounts as a "tax-free" exchange under sec. 354(a)(1), I.R.C. 1954. *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 970 (1979); *West Side Fed. S. & L. Ass'n of Fairview Pk. v. United States*, 494 F.2d 404 (6th Cir. 1974); and *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971), followed.

Duane Tewell and *David Tewell*, for the petitioners.

Wayne R. Appleman, for the respondent.

OPINION

FEATHERSTON, *Judge*: Respondent determined a deficiency in the amount of $40,913 in petitioners' Federal income tax for 1976. The only issue for decision is whether

the exchange of "guaranty stock" in a State-chartered savings and loan association for passbook accounts and time certificates of deposit in a Federally-chartered mutual savings and loan association qualifies as a tax-free exchange under section 354(a).[1]

This case was submitted fully stipulated.

At the time the petition was filed, petitioners Harold T. and Marie B. Paulsen, husband and wife at all times material herein, resided in Tacoma, Washington. They filed a joint Federal income tax return for 1976 with the Internal Revenue Service Center, Ogden, Utah.

During the 12-month period preceding June 30, 1976, petitioner Harold T. Paulsen was the president and a director of Commerce Savings and Loan Association of Tacoma (Commerce). Commerce, a State chartered savings and loan association, was incorporated and operated under the laws of the State of Washington.

Under its articles of incorporation and bylaws, Commerce was authorized to issue "guaranty stock" and several classes of savings accounts. Each holder of a savings account or guaranty stock, as well as each borrower, was a "member" of Commerce. With respect to all questions requiring action by the members, holders of savings accounts received one vote for each $100 in their accounts, and guaranty stockholders received one vote per share of stock. Each borrower from Commerce was also entitled to one vote. A majority of the board of directors of Commerce were required to be owners of guaranty stock.

A minimum amount of guaranty stock, specified by a formula, was required to be "maintained as fixed and permanent nonwithdrawable capital" of Commerce. Guaranty stockholders had a proportionate proprietary interest in the assets and net earnings of Commerce subordinate to the claims of its creditors; no other member had such an interest.[2] Guaranty stock was not eligible as a security for loans from Commerce, and it could not be "withdrawn" until the claims of all creditors and holders of savings accounts had been satisfied upon liquidation or dissolution. Dividends on guaranty stock could not be declared unless certain reserves had been accumulated, and they could not be paid or credited during any period in which dividends had not been declared and paid upon withdrawable savings. The rate of dividends on guaranty stock was to be fixed by the board of directors.

On June 30, 1976, petitioners owned 17,459 shares of guaranty stock in Commerce. Of these shares, 1,390 shares were acquired on that day pursuant to a qualified stock option plan of Commerce. All of petitioners' stock in Commerce was held as community property.

Citizens Federal Savings and Loan Association of Seattle (Citizens or the association) is a Federally-chartered mutual savings and loan association which was authorized, organized, and chartered by the Federal Home Loan Bank Board under the provisions of 12 U.S.C. sec. 1461, et seq., and

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[1]All section references are to the Internal Revenue Code of 1954, as in effect during the tax year in issue, unless otherwise noted.

[2]The bylaws submitted with the stipulation state that "each holder of a savings account or guaranty stock" shall have a proportionate proprietary interest in the assets or net earnings. However, they further state that any provision of the bylaws in conflict with State law "shall be deemed amended to conform therewith." During the years in question, Wash. Rev. Code Ann. sec. 33.48.080 (Supp. 1981), provided as follows:

> Each member having guaranty stock in an association shall have a proportionate proprietary interest in its assets and net earnings subordinate to the claims of its creditors * * *; but [subject to an exception not pertinent here] no other member * * * shall have any such interest * * *.

the regulations promulgated thereunder. Citizens has no capital stock. It is owned by its members who consist solely of savings account holders and borrowers. In the consideration of questions requiring action by its members, each holder of a savings account has one vote for each $100 (or fraction thereof) of the withdrawal value of his savings account, and each borrower has one vote.

The charter of Citizens states in part that the "objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economical financing of homes." Under the charter, Citizens has the power to raise capital only "by accepting payments on savings accounts representing share interests in the association." Generally speaking, requests for withdrawals from savings accounts must be honored within 30 days of the request. In this connection, Citizens' charter provides that: "Holders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid and shall not become creditors." All savings accounts of Citizens are "nonassessable."

The Citizens charter further provides that as of June 30 and December 31 of each year, after provision has been made for payment of expenses, credits to general reserves and surplus, and bonuses on savings accounts as authorized by Federal Home Loan Bank Board regulations, any remaining net earnings are to be distributed in proportion to the withdrawal value of savings accounts. In lieu of or in addition to such net earnings, any surplus of the association may be similarly distributed. In the event of voluntary or involuntary liquidation, dissolution, or winding up of Citizens, all holders of savings accounts are "entitled to equal distribution of assets, pro rata to the value of their savings accounts." Citizens has the power to redeem all or any part

of its savings accounts at a price equivalent to "the full value thereof, as determined by the board of directors, but in no event shall the redemption price be less than the withdrawal amount" of any savings account.

On or about July 1, 1976, the guaranty stockholders of Commerce exchanged all of their stock for passbook accounts and time certificates of deposit in Citizens. This exchange was made in accordance with the provisions and intent of a "Plan for Merger" of Commerce and Citizens dated November 7, 1975.

Pursuant to the provisions of the plan for merger, each share of guaranty stock in Commerce was to be exchanged for a $12 deposit in a regular passbook savings account in Citizens, subject to the restriction that such deposits could not be withdrawn for a period of 1 year. Alternatively, Commerce shareholders had the option of exchanging their stock (at the same dollar rate per share) for time certificates of deposit in Citizens with maturities ranging from 1 to 10 years.[3] The plan for merger further provided that each prior shareholder of Commerce would have borrowing privileges against the deposits resulting from the exchange of stock at an interest rate 1.5 percent above the passbook rate.[4]

Upon completion of the exchange, Commerce was merged into Citizens and the combined business activity of the two was continued in the name of Citizens.[5] The exchange and

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[3]Although this option was within the intent of the parties to the merger, through a typographical error, the plan for merger does not reflect the terms of the option.

[4]Generally, Citizens savings account holders were charged interest at a rate 2 percent above the passbook rate on loans secured by their accounts. The passbook rate during the period July 1, 1976 through June 30, 1977, was 5.25 percent.

[5]Each Commerce savings account outstanding on the effective date of the merger was converted to a savings account of the same size in Citizens.

merger were treated by Citizens and Commerce as a reorganization under section 368(a)(1)(A) resulting in no recognized gain or loss to Commerce shareholders pursuant to section 354(a).

On July 1, 1976, in accordance with the above-described plan for merger, petitioners exchanged the following shares of guaranty stock in Commerce for passbook accounts and time certificates of deposit in Citizens:

Number of Shares	Date of Acquisition	Cost Basis	Consideration Received		Gain Realized
			Amount	Type	
3,356	3/ 8/63	$ 7,500	$ 40,272	Passbook	$ 32,772
3,359	6/26/70	7,500	40,308	2 yr. cert.	32,808
3,358	12/31/71	7,500	40,296	18 mos. cert.	32,796
3,358	10/24/72	7,500	40,296	18 mos. cert.	32,796
667	1/ 1/73	7,530	8,004	1 yr. cert.	474
1,971	2/19/74	6,000	23,652	3 yr. cert.	17,652
861	6/30/76	7,500	10,332	3 yr. cert.	2,832
529	6/30/76	5,772	6,348	4 yr. cert.	576
17,459		$56,802	$209,508		$152,706

Petitioners treated this exchange as one requiring the recognition of the gain realized only upon the withdrawal of monies from the passbook accounts or upon the maturity of the time certificates of deposit. Therefore, they reported no gain from the exchange on their Federal income tax return for 1976.[6]

Respondent determined in the notice of deficiency that petitioners were required to recognize in 1976 the gain realized from the exchange of the Commerce stock for Citizens passbook accounts and time certificates of deposit.

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[6]Petitioners had made no withdrawals from their passbook accounts between July 1, 1976, and the date that the stipulation was submitted. The record does not indicate whether petitioners had reported gain upon the maturity of any of the time certificates.

Under section 1001,[7] the entire amount of any gain realized on the sale or exchange of property must be recognized for income tax purposes unless it is otherwise provided in the Code. Section 354(a)[8] provides in part that no gain shall be recognized if pursuant to a plan of reorganization, stock or securities in a corporation that is a party to the reorganization are exchanged for stock or securities in another corporation that is a party to the reorganization.

As used in section 354(a), the term "reorganization" includes a merger or consolidation effected under applicable

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[7]SEC. 1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS.

(a) Computation of Gain or Loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount Realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. * * *

(c) Recognition of Gain or Loss.—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

* * *

[8]SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) General Rule.—

(1) In general.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) Limitation.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) Cross reference.—For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

State or Federal law. Sec. 368(a)(1)(A); sec. 1.368-2(b)(1), Income Tax Regs. It is undisputed that the merger of Commerce and Citizens was effected as authorized by law. However, treatment of the merger as a "reorganization" for tax purposes does not necessarily follow from the fact that it was formally conducted in accordance with applicable law. There is an additional requirement, judicially created and now set forth in section 1.368-1(b), Income Tax Regs., that there be a "continuity of interest" on the part of those persons who owned the enterprise prior to the merger.[9] Generally speaking, this means that the owners of an acquired corporation must receive a proprietary interest[10] in the modified enterprise resulting from a transaction which purports to be a "reorganization."[11] For purposes of this case, it means that, in order for us to find a "reorganization" and for section 354(a) to apply, the consideration received by petitioners in exchange for Commerce guaranty stock must be characterized as stock in citizens.[12] See *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 970, 973-974 (1979).

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[9]For a review of the development of the continuity-of-interest test, see *West Side Fed. S. & L. Ass'n of Fairview Pk. v. United States*, 494 F.2d 404, 406-408 (6th Cir. 1974). See generally Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders, par. 14.11 (4th ed. 1979) (hereinafter Bittker & Eustice), discussing the evolution of the test and its application to not only mergers, but to the other types of transactions defined as "reorganizations" in sec. 368(a)(1).

[10]The interest received is subject to both qualitative and quantitative restrictions. Bittker & Eustice, par. 14.11 at p. 14-20.

[11]The continuity-of-interest doctrine was devised as a means of denying tax-free status to otherwise taxable transactions (such as sales) that happen to meet the literal definition of a reorganization. Bittker & Eustice, pars. 14.03 and 14.11.

[12]Sec. 354(a) permits the receipt of "stock or securities" pursuant to a plan of reorganization; however, the receipt of securities *alone* will not satisfy the continuity-of-interest test. *LeTulle v. Scofield*, 308 U.S. 415 (1940). Petitioners and the other guaranty stockholders of Commerce received only one type of consideration from Citizens (i.e., savings accounts evidenced by passbooks and time certificates), and it must, therefore, be classified as "stock" if petitioners are to prevail.

Not surprisingly, petitioners contend that they exchanged guaranty stock in Commerce for "stock" in Citizens pursuant to a plan of reorganization and that, under section 354(a), no gain was required to be recognized on the exchange. They emphasize that, like shareholders in a corporation that does issue "stock" in the traditional sense, holders of savings accounts in Citizens have voting rights, the right to pro rata distributions of earnings and surplus, and the right to share in Citizens' assets upon liquidation. See Bittker & Eustice, par. 14.31 at 14-94 and 14-95. In support of their position, petitioners also point out that section 7701(a)(7) and (8) defines the terms "stock" and "shareholder" as follows:[13]

> (7) Stock.—The term "stock" includes shares in an association, joint-stock company, or insurance company.
>
> (8) Shareholder.—The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

Respondent's position is that the merger of Commerce into Citizens was not a "reorganization" for tax purposes because petitioners and the other guaranty stockholders of Commerce did not receive a significant proprietary interest in Citizens and that, therefore, section 354(a) has no application here. Respondent acknowledges that, to some extent, the savings accounts received by petitioners represent an equity interest in Citizens, but he emphasizes that they are not the equivalent of ordinary shares of stock. Rather,

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[13]These definitions apply only "where not otherwise distinctly expressed or manifestly incompatible with the intent" of the provision in questiion. Sec. 7701(a). Thus, they are not necessarily determinative of the issue presented here. See *Carlberg v. United States*, 281 F.2d 507, 513-514, fns. 8 and 9 (8th Cir. 1960).

respondent argues, a savings account in Citizens is the equivalent of cash; he views the relationship between a savings account holder and Citizens as basically one of creditor and debtor because, he contends, for all practical purposes a Citizens savings account is withdrawable upon written demand.[14] Respondent would thus characterize a savings account in Citizens as "a hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" which are not sufficient to meet the requirements of the continuity-of-interest test in the circumstances of this case.[15]

The question whether savings accounts in a Federally-chartered mutual savings and loan association may be characterized as "stock" for purposes of the provisions of the Internal Revenue Code relating to tax-free reorganizations has not heretofore been considered by this Court. However, the issue has been decided by a number of other courts, and they have uniformly rejected the position here taken by respondent.

In *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971), a State-chartered building and loan association with both "permanent shares" and "savings shares" outstanding had transferred its assets to a Federally-chartered mutual

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[14]Respondent minimizes the effect of the 1-year restriction on withdrawal from the savings accounts received by the guaranty stockholders of Commerce by emphasizing that they had borrowing privileges against those deposits.

[15]See Rev. Rul. 69-6, 1969-1 C.B. 104. Respondent has ruled, however, that the proprietary interest represented by savings accounts such as the ones in question is sufficient for purposes of the continuity-of-interest test in cases involving the merger of two mutual savings and loan associations. See Rev. Rul. 69-3, 1969-1 C.B. 103; Rev. Rul. 78-286, 1978-2 C.B. 145 (continuity-of-interest test satisfied even in the absence of voting rights). Cf. Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of building and loan association having only savings accounts into one having savings accounts and guaranty shares held to satisfy the continuity-of-interest requirement).

savings and loan. Holders of savings shares in the State association received like shares in the Federal association. In additon, $65,000 was paid to the State association and distributed to its permanent shareholders in a complete liquidation. The taxpayers treated the transaction as a reorganization within the meaning of section 368(a)(1)(C) and (2)(B), and the correctness of their so doing turned on the question whether savings shares in the Federal association constituted "voting stock" within the meaning of that section. The court held that they did, noting that although "such shares have some of the indicia of a creditor-debtor relationship, nevertheless at the same time such shares also possess many of the attributes of a proprietary type interest.[16] *Everett v. United States, supra* at 360. The court went on to hold that the transaction met the continuity-of-interest test[17] even though the permanent shareholders of the State association had been "cashed out."

A similar conclusion was reached in *West Side Fed. S. & L. Ass'n of Fairview Pk. v. United States*, 494 F.2d 404 (6th Cir. 1974) (hereinafter *West Side*), which in all material respects is identical to the case before us. There, the issue was whether the statutory merger of a State-chartered savings and loan into a Federally-chartered mutual savings and loan was a "reorganization" within the meaning of section 368(a)(1)(A). Each savings account in the State association had been exchanged for a savings account of

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[16]The proprietary rights focused on by the court—i.e., the right to vote and participate in management, the right to bonus payments contingent on earnings, and the right to share in liquidation proceeds—were basically the same as those possessed by holders of savings accounts in Citizens.

[17]It should be noted that the requirement of sec. 368(a)(1)(C) that an exchange be "solely" for "voting stock" is stricter than the judicially-created continuity-of-interest doctrine. See *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 198 (1942).

equal value in the Federal association, and each share of capital stock in the State association had been converted into a savings account in the Federal association with a withdrawal value of $2,500. The Government argued that this transaction failed to meet the requirement of a continuity of proprietary interest, stressing the fact that prior to the merger the State association had two distinct classes of contributors to its capital. It also emphasized the fact that (1) savings accounts in the Federal association were withdrawable at any time with little or no restriction, (2) such savings accounts were Federally insured, and (3) voting rights attaching to such savings accounts were more restricted than the rights enjoyed by the former shareholders of the State association.

The court in *West Side* emphasized that cases dealing with the continuity-of-interest requirement have focused upon the nature of the interest received and that it need not be identical to the interest given in an exchange.[18] This being so, and because a savings account is the only proprietary interest available in a Federal mutual savings and loan association, the court stated that "it is improper to ignore the proprietary rights * * * [of holders of these savings accounts] and concentrate only on their rights as creditors." 494 F.2d at 411. The court held that the exchange of savings accounts and stock in the State association for savings accounts in the Federal association satisfied the continuity-of-interest test. Specifically, it found that each owner of a proprietary interest in the State association had acquired a proprietary interest in the Federal association which was definite and material and which represented a substantial

[18]The court concluded its opinion with a quote from *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935), as follows: "True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute."

part of the value of the stock that was given up.

The same result was reached by the Court of Claims in *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 970 (1979) (hereinafter *Capital*), also involving the question whether the merger of a savings and loan association having guaranty stock into a mutual savings and loan association[19] qualified as a reorganization under section 368(a)(1)(A). Pursuant to an agreement of merger, all savings accounts and guaranty stock of the acquired association were converted into voting withdrawable savings accounts in the mutual association. The Government argued that the holders of guaranty stock had "cashed in" or sold their equity interest by accepting withdrawable savings accounts in exchange for the stock and that, therefore, the merger failed to meet the continuity-of-interest test.

The Court of Claims observed that there were several problems with the Government's argument that savings accounts in mutual savings and loan associations should be treated simply as debt interests, "beginning with the fact that these accounts are hybrid interests having the seemingly inapposite characteristics of both equity interests and debt interests." *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. at ___, 607 F.2d at 974. As in *West Side, supra*, the court noted that in cases involving the continuity-of-interest doctrine the focus must be on the nature of the interest received in an exchange and that savings accounts are the only interests with proprietary and equity rights available in a mutual savings and loan. In holding that the merger in question did qualify as a reorganization under section 368(a)(1)(A), the Court of Claims stated (*Capital S. & L.*

[19]Apparently, both of the savings and loan associations that were parties to the merger in *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. 557, 607 F.2d 907 (1979), were incorporated under the laws of the State of Washington, as was Commerce.

Ass'n v. United States, 221 Ct. Cl. at ___, 607 F.2d at 976):

> As the law assumes that someone must own an association or corporation, we join the courts in *West Side, supra*, and *Everett, supra*, in refusing to reach a decision which illogically implies that * * * [a mutual savings and loan association is] without owners and which may unduly hinder otherwise desirable reorganizations. Though savings accounts are easily converted into cash, as long as the account remains unliquidated, its holders continue their equity investment in the association in the form of share accounts. * * * [Fn. reference omitted.]

Thus, in these and other cases,[20] the courts have uniformly rejected respondent's argument that the receipt of savings accounts in a mutual savings and loan association in exchange for stock will not satisfy the continuity-of-interest test. The courts have recognized the hybrid nature of accounts in mutual savings and loan associations but have concluded that such proprietary rights as the right to vote, the right to receive pro rata distributions of earnings, and the right to share in distributions of assets upon liquidation are sufficient to cause such accounts to meet the continuity-of-interest requirement. Respondent cites only one case involving this question in support of his position, *Home Savings and Loan Ass'n v. United States*, 514 F.2d 1199 (9th

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[20]In addition to *Everett, West Side*, and *Capital*, cases holding that a savings account in a mutual savings and loan constitutes "stock" for purposes of finding a reorganization include *Rocky Mtn. Fed. Sav. & L. Ass'n v. United States*, 473 F.Supp. 779 (D. Wyo. 1979) (merger of State stock savings and loan into Federal nonstock savings and loan), and *First Federal Sav. and Loan Ass'n v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978) (same).

It has also been recognized outside the area of reorganizations that savings accounts in mutual savings and loan associations represent equity interests. See the discussion and cases cited in *Capital*, 221 Ct. Cl. at ___, 607 F.2d at 975.

Cir. 1975), and that case—involving guaranty stock associations on both sides of the merger transaction—is readily distinguishable from cases like the instant one where stock in a savings and loan association was exchanged for savings accounts in a mutual savings and loan.[21]

We recognize that respondent is not without arguments and that treating savings accounts as "stock" for purposes of the "tax-free" reorganization provisions of the Internal Revenue Code raises a number of logical and practical ad-

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[21]In *Home Savings and Loan Ass'n v. United States*, 514 F.2d 1199 (9th Cir. 1975), the taxpayer, a State savings and loan association having guaranty stock in addition to "withdrawable shares," acquired two other State guaranty stock savings and loan associations in a transaction that it characterized as a reorganization. Home first purchased for cash all of the outstanding guaranty stock of the two acquired associations. Subsequently, the acquired associations were merged into Home. Upon the merger, the guaranty stock of the acquired associations was cancelled, and the holders of "withdrawable shares" and "investment certificates" in the acquired associations exchanged them for "withdrawable shares" in Home. Based primarily upon California law and the terms of the instruments before it, the court held that the withdrawable shares and investment certificates of the acquired associations could not be considered as "stock" for purposes of sec. 368(a)(1)(A). Rather, they were found to be debt instruments and, because the former owners of the acquired associations (i.e., the guaranty stockholders) had been "cashed out," the transaction was held to lack the continuity of interest requisite to a valid "reorganization."

In the present case, the question whether the holders of savings accounts in the acquired association (Commerce), as well as its guaranty stockholders, may be considered as its former owners is not in issue. Here, the question whether there is sufficient continuity of interest depends upon the nature of the savings accounts that the guaranty stockholders received from Citizens, a mutual savings and loan association having only savings accounts and no stock per se. The Ninth Circuit in *Home Savings and Loan Ass'n v. United States, supra*, at 1208-1209, made it clear that the nature of such savings accounts was not there in issue, stating in this connection that:

> Assuming that there must exist in all associations a proprietary interest, such broad and uniform interest may well serve that purpose. Its capacity to do so should not be impaired by the fact that it also may constitute debt. However this may be, we are not confronted here with such a case. [Fn. reference omitted.]

ministrative problems.[22] If this were a question of first impression, we would feel free to give greater weight to those problems in reaching our decision. Given the long outstanding and unbroken line of holdings of the several cited judicial authorities, however, that savings accounts in a mutual savings and loan association qualify as "stock," we feel constrained to follow the guidance of those decisions, the first of which is now over 10 years old. A corporate reorganization, in which the stakes are usually very high, requires careful advance planning and, consequently, the need for certainty in the law is great. The practicality of many reorganizations is materially affected, if not determined, by the tax consequences, and the participants need to know the ground rules. The current plight of the savings

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[22]For example, the general purpose of the reorganization provisions is to postpone the recognition of gain realized upon the shifting of business interests into a modified corporate form. Thus, under sec. 358(a)(1), the basis of property received in a reorganization exchange (here, the savings accounts) is the same as the basis of the property surrendered (the guaranty stock). The amount of petitioners' bases for their several blocks of stock, as shown above, is much less than the amounts in the savings accounts they received and yet, practically speaking, savings accounts are viewed as the equivalent of cash.

Petitioners suggest that the gain realized from the exchange of guaranty stock for savings accounts should be recognized only upon withdrawals from the passbook accounts and upon the maturity of the time certificates. (It is unclear as to whether petitioners suggest that the time certificates should be taxed upon maturity even though the funds are not withdrawn.) The withdrawal from a savings account does not constitute a "sale or exchange" as those terms are generally understood, but such withdrawals could be viewed as the proceeds of redemptions to be tested under the provisions of sec. 302(b). If both deposits and withdrawals were made with respect to savings accounts received in an exchange for stock, i.e., unless the accounts received in the reorganization are kept carefully separate, serious problems of determining the shifting bases of the accounts and the character of the withdrawals would arise.

In the final analysis, however, given the hybrid nature of the savings accounts in question, logical and practical problems would arise regardless of whether the accounts are treated as a debt interest or as an equity interest.

and loan industry[23] brings to mind Justice Powell's statement in *United States v. Byrum*, 408 U.S. 125, 135 (1972):[24]

> When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

We hold for petitioners.[25]

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[23]See, e.g., H. Rept. No. 97-201, to accompany H.R. 4242 (Pub. L. 97-34), 145-146 (1981); Wall Street Journal, Feb. 18, 1982, at 4, cols. 1 and 2; Washington Post, Feb. 22, 1982, at A1, col. 3 and A12, col. 1.

[24]Paraphrasing the words of the Supreme Court in *United States v. Byrum*, 408 U.S. 125, 134, fn. 8 (1972), we are not so much concerned with whether petitioners relied on the precedents discussed herein, but with the probability that others have relied on them in good faith in planning and carrying out mergers of savings and loans. At least with respect to the question of the character of savings accounts in a Federally-chartered mutual savings and loan, a uniform rule should be applied nationwide. See and compare *Allstate Sav. & Loan Ass'n v. Commissioner*, 600 F.2d 760, 762 (9th Cir. 1979), affg. 68 T.C. 310 (1977).

[25]Respondent has made an alternative argument that, if the receipt of savings accounts in Citizens is sufficient for purposes of the continuity-of-interest test, the accounts nonetheless constitute "other property" ("boot") for purposes of sec. 356(a)(1) and, therefore, result in recognized gain to petitioners. Respondent submits that this argument is consistent with the decisions of the courts in *Everett*, *West Side*, and *Capital*, *supra*.

Although respondent's alternative argument may in the abstract be consistent with the holdings of those cases, we think the argument fails to comport with the facts of either those cases or the present case. Sec. 356(a)(1) applies where property qualifying for "tax-free" exchange under sec. 354 and, *in addition*, some other property or money is received. Here, petitioners received only one type of property, savings accounts (in the form of passbooks and time certificates), and the cash deposit and proprietary rights represented by those accounts are not separable. See *Capital S. & L. Ass'n v. United States*, 221 Ct. Cl. at ___, 607 F.2d at 977. Respondent seems to have recognized as much in Rev. Rul. 69-6, 1969-1 C.B. 104, where it is stated that the obligation

(footnote continued on following page)

To reflect the foregoing,

Decision will be entered for the petitioners.

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of a Federal nonstock mutual association to deliver cash deposits "is not severable from its obligation to deliver * * * a proprietary interest. Both the cash equivalents and the proprietary interests are evidenced" by savings accounts. Given this inseparability of rights, we think this case must turn solely on the question whether the savings accounts are "stock." We find no merit in respondent's alternative argument.

Decision of the United States Tax Court.

United States Tax Court, Washington, D.C. 20217.

Harold T. and Marie B. Paulsen, Petitioners, v. Commissioner of Internal Revenue, Respondent. Docket No. 17549-79.

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion, filed March 2, 1982, it is

ORDERED AND DECIDED that there is no deficiency in petitioners' Federal income tax for the taxable year 1976.

/s/ C. Moxley Featherston
C. Moxley Featherston
Judge

Entered: MAR 8 1982

Opinion of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Harold T. and Marie T. [sic] Paulsen, Appellees vs. Commissioner of Internal Revenue, Appellant. No. 82-7329. Tax. Ct. No. 17549-79.

Filed: August 16, 1983.

Appeal from the United States Tax Court.

Argued and Submitted April 5, 1983. Decided ....., 1983.

BEFORE: HUG, POOLE, AND NORRIS, Circuit Judges.

NORRIS, Circuit Judge:

Pursuant to a merger plan between a stock savings and loan association and a mutual savings and loan association, shareholders in the stock association exchanged their "guaranty shares" for passbook accounts and time certificates of deposit in the mutual association. The Tax Court, believing that it was "constrained to follow the guidelines of several circuit court decisions holding [transactions such as this one to be tax free]," held the exchange to be a stock for stock transaction not taxable under 26 U.S.C. § 354. *Paulsen v. Commissioner*, 78 TC 291, 302-303, 303 n.24 (1982).

On appeal, the Government argues that the predominant characteristics of the passbook accounts and time certificates received in the exchange are those of debt rather than those of equity, and that, in reality, the shareholders simply sold their guaranty shares for the equivalent of cash. We agree and therefore reverse.

I

The material facts are not in dispute.

Commerce Savings and Loan Association (Commerce) was a stock savings and loan association chartered by the State of Washington and authorized to issue guaranty stock,

to offer various clases of savings accounts, and to make loans. Each holder of a savings account or of guaranty stock and each borrower was a "member" of Commerce. With regard to matters requiring the approval of Commerce's members, holders of guaranty stock were entitled to one vote per share, holders of savings accounts to one vote per $100 on deposit, and borrowers to one vote each.

A certain amount of guaranty stock was "nonwithdrawable" and constituted the fixed capital of Commerce. Under state law, only holders of guaranty stock had a proprietary interest in the assets and net earnings of Commerce. Guaranty stockholders were entitled to elect a majority of Commerce's board of directors.

Harold T. Paulsen was president and a director of Commerce. On June 30, 1976, he and his wife owned 17,459 shares of Commerce guaranty stock with a cash basis of $56,802.

Citizens Federal Savings and Loan Association (Citizens) is a federally chartered mutual savings and loan association. As a mutual savings and loan association, it has no capital stock. Instead, it is "owned" by its depositors. With regard to matters on which management must obtain approval, each holder of a savings account is entitled to one vote per $100 on deposit (or fraction thereof), up to a maximum of 400 votes. Each borrower from Citizens is also entitled to one vote.

Citizens' articles and bylaws provide that twice each year Citizens' net earnings and any surplus are to be distributed to savings account holders on a pro rata basis. In the event of the liquidation or dissolution of Citizens, savings account holders are entitled to a pro rata distribution of its assets. Citizens must also honor requests by its savings account holders to withdraw funds within thirty days. Citizens may

"redeem" any of its savings accounts at any time by paying to the holder the "withdrawal amount", i.e., the amount on deposit.

On July 1, 1976, Commerce was merged into Citizens. Under the merger plan, shareholders of Commerce were to exchange their guaranty shares for passbook accounts and time certificates of deposit in Citizens. Each guaranty share of Commerce was to be exchanged for a $12 deposit in a Citizens passbook account, subject to the restriction that such deposits could not be withdrawn for one year. Alternatively, Commerce shareholders could exchange their guaranty stock for time certificates of deposit in Citizens with maturities ranging from one to ten years, again at the rate of $12 per share. Although under either option former Commerce shareholders would not receive cash immediately, the merger plan authorized them to borrow against such accounts at an interest rate of 1.5 percent above the passbook rate. Normally, Citizens savings account holders could borrow at a rate of 2 percent higher than the passbook rate.

On July 1, 1976, the Paulsens exchanged their 17,459 shares of Commerce guaranty stock for passbook accounts and certificates of deposit as follows:

Number of Shares	Date of Acquisition	Cost Basis	Consideration Received		Gain Realized
			Amount	Type	
3,356	3/ 8/63	$7,500	$40,272	Passbook	$ 32,772
3,359	6/26/70	7,500	40,308	2 yr. cert.	32,808
3,358	12/31/71	7,500	40,269	18 mos. cert.	32,796
3,358	10/24/72	7,500	40,296	18 mos. cert.	32,796
667	1/ 1/73	7,530	8,004	1 yr. cert.	474
1,971	2/19/74	6,000	23,652	3 yr. cert.	17,652
861	6/30/76	7,500	10,332	3 yr. cert.	2,832
529	6/30/76	5,772	6,348	4 yr. cert.	576
17,459		$56,802	$209,508		$152,706

The Paulsens determined that the merger was a reorganization as described in § 368(a)(1) and that their gain from the transaction was tax free under § 354(a). They therefore did not report the gain on their 1976 income tax return.

The Commissioner issued a statutory notice of deficiency, asserting that the Paulsens were liable for tax on the entire amount. The Paulsens petitioned the Tax Court for redetermination of deficiency. The Tax Court held that the passbook accounts and the time certificates of deposit were to be classified as stock for purposes of § 354 and that the exchange was therefore not taxable. 78 T.C. at 303. The Commissioner filed a timely appeal.

II

In general, all gain from the sale or exchange of property is taxable unless exempted by a specific provision of the Code. 26 U.S.C. § 1001. Section 354 is such a provision. It states in part that:

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

26 U.S.C. § 354(a)(1).

Describing the purpose of § 354, one commentator has written:

> The theory behind [§ 354] is that where a stockholder enters into a reorganization exchange (e.g. a merger), he receives stock of a different corporation from that in which he held stock before, thereby realizing gain. However, since his investment is still tied up in the corporate form, economically he is not very much better off than he was before — for example, he still has no money with which to pay the tax — and consequently, as a matter of congressional policy, gains are

> not recognized at this point. Instead, through the carryover basis provisions, taxation of gain on this exchange is postponed until he disposes of the stock received in the merger in some form of taxable exchange.

Stanley & Kilcullen, *Federal Income Tax Law* 7-8 (1983).

Section 354 applies only when "stock or securities" are exchanged for like property pursuant to a plan of "reorganization". To ensure that the purpose of § 354 is met, courts have added to the definition of reorganization a "continuity of interest" requirement which in the case of statutory mergers is satisfied only if the equity interest of the shareholders in the acquiring enterprise is continued in the new enterprise. *See Home Savings and Loan Ass'n v. United States*, 514 F.2d 1199, 1201 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975); B. Bittker and J. Eustace, *Federal Income Taxation of Corporations and Shareholders*, para. 14.11 (4th ed. 1979).

The interest received need not be the same form of equity interest as that given up. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935). Furthermore, the transferor may receive some cash or other property, as long as he or she receives in addition an equity interest in the acquiring corporation that represents a substantial part of the value of the interest given up. *Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935). The "continuity of interest" requirement is not satisfied, however, if the transferor of shares in the acquired corporation receives only debt and becomes merely a creditor of the new enterprise. *See* B. Bittker and J. Eustace, *supra*; *see also Le Tulle v. Scofeld*, 308 U.S. 415 (1940).

In the discussion that follows, we consider first whether the accounts received by the Paulsens should be characterized as equity, in which case nonrecognition of gain would be appropriate or as debt, in which case recognition is required. We conclude that debt characteristics overwhelmingly predominate.

III

The Paulsens argue that they exchanged their guaranty shares in Commerce for interests in Citizens that too had significant proprietary characteristics. First, they contend, their interests should be considered equity for purposes of section 354 because as holders of Citizens accounts they are entitled to all the rights generally held by shareholders, including the right to vote, the right to share in the profits of the association, and the right to share in any proceeds that may be available should Citizens liquidate. Second, they point out that under the Code, stock is defined to include "shares in an association," 26 U.S.C. § 7701(a)(7), and shareholder is defined to include "member of an association," 26 U.S.C. § 7701(a)(8). Third, the Paulsens argue that Citizens biannual distributions of earnings are "dividends." They note that under Citizens' charter, management is authorized to determine periodically whether any payments are to be made, and their amounts; that the payments are expressly dependent on the financial success of the Association; and that Citizens is not contractually obligated to its depositors to make any payments. This, too, they argue is typical of equity. Finally, the Paulsens note that the interests they received, passbook accounts and certificates of deposit, are the only form of proprietary interest available in Citizens. Thus, regardless of any debt characteristics the instruments they received must have, they argue, they received all of the equity there was to receive. In short, the Paulsens suggest that to hold that their interests are not equity would be to hold that no equity exists in Citizens at all.

The arguments advanced by the Paulsens are virtually identical to those make [sic] by the plaintiff in *Home Savings and Loan Association v. United States*, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975). In that case,

plaintiff *Home Savings*, a stock savings and loan association, had acquired the stock of Pasadena Savings and Loan Association (Pasadena) and Savings and Loan Association of Anaheim (Anaheim). Each of the two acquired associations had two forms of capital. Both had guarantee stock, the proceeds of which were required by California law to be set aside and maintained "as a fixed and permanent capital of the association." *Id.* at 1202. In addition, Pasadena had withdrawable shares, which enjoyed no statutory entitlement to interest, were liable for debts or assessments of the corporation and were subordinated to the interests of creditors in the event of a liquidation. Anaheim, on the other hand, had investment certificates which, in contrast to withdrawable shares, had a statutory right to interest, were not liable for corporate debts or assessments, and had priority in a liquidation. *Id.* at 1202-03. The acquisition by Home was effected by Home purchasing the guarantee shares of the two associations and exchanging its withdrawable shares for the withdrawable shares of Pasadena and the investment certificates of Anaheim. The question before the court was whether that transaction more nearly resembled a stock purchase than a tax-free reorganization. The answer to that question depended on whether the withdrawable shares and investment certificates were classified as debt or as equity.

To make that determination, the *Home Savings* panel carefully examined the characteristics of the interests Home acquired from Pasadena and Anaheim, and concluded that

> [n]either withdrawable shares nor investment certificates under the circumstances of this case partake sufficiently of equity characteristics to permit their classification as such.

Id. at 1206. We conduct the same examination of the interests acquired in the Citizens merger, comparing them to

those found to be debt in *Home Savings*. Our examination compels the conclusion that, like the interests acquired in *Home Savings*, the interests we must classify in this case do not "partake sufficiently of equity characteristics," *id.* to so classify them.

First, there are indeed some voting rights attached to the Citizens passbook accounts. Yet as we noted in *Home Savings*, under California law holders of debt can be afforded voting rights. 514 F.2d at 1206; Ca. Corp. Code § 306. Thus the fact that voting rights are attached to a particular interest does not make it equity. Moreover, the voting rights received by Citizens depositors are quite dissimilar to those of holders of equity interest in other corporations. Every holder of a Citizens savings account is entitled to one vote per $100 on deposit (up to a maximum of 400 votes). Yet the Paulsens' proportional ownership and their voting power are, unlike that of shareholders in other entities, infinitely dilutable. The addition of any depositor dilutes the voting power of all. Finally, the Paulsens have not refuted the Commissioner's contention that in practice depositors generally sign proxies giving management their vote upon opening accounts. *See York v. Federal Home Loan Bank Board*, 624 F.2d 495, 497 n. 1 (4th Cir.), *cert. denied*, 449 U.S. 1043 (1980). Thus whatever formal right to vote the depositors may possess, they sign away upon depositing their first dollar.

Second, though Citizens does indeed distribute what it calls "dividends," taxpayers do not dispute the Commissioner's assertion that in fact Citizens pays a fixed, preannounced rate on all accounts. In practice, the distributions are identical in all essential respects to the interest paid by stock savings and loan associations. Indeed, as a matter of economic common sense they would have to be. It is fanciful to suggest that depositors deciding where to put their money

attach any weight to whether an institution is a mutual or a stock association. Indisputably, they are motivated by the amount of interest they can receive and the security of their deposits. Thus, again as we noted in *Home Savings*, competition will "assure withdrawable shareholders a reasonably steady rate of return," and will assure that interest paid by mutual associations is competitive with interest paid by stock associations and commercial banks. 514 F.2d at 1206. Our court in *Home Savings* was also persuaded to classify the withdrawable shares and investment certificates as debt by the fact that the Internal Revenue Code treated the instruments exactly as it does interest. They were deductible to the payor, 26 U.S.C. § 591, and did not qualify for the dividend exclusion of § 116. Because the same is true of the so-called dividends paid by Citizens, we are equally persuaded that those payments do not qualify the passbook accounts as equity.

Third, the Paulsens' right to share in the proceeds in the speculative and unlikely event of a solvent liquidation cannot be considered a significant part of the value of the interest they received in exchange for their guaranty stock and thus cannot be considered as a significant factor in determining whether what they received was debt or equity. The *Home Savings* panel attached no weight to similar rights acquired by the plaintiff in that case, and the Supreme Court aptly described the significance of liquidation rights such as the Paulsens in *Society for Savings v. Bowers*, 349 U.S. 143, 150 (1955) when it noted that

> it stretches the imagination very far to attribute any real value to such a remote contingency [as a solvent liquidation], and when coupled with the fact that it represents nothing which the depositor can readily transfer, any theoretical value reduces almost to the vanishing point.

Finally, the *Home Savings* panel found very persuasive the fact that the interests that *Home* received, besides being dissimilar to normal equity interests, had many of the normal characteristics of debt. The withdrawable shares and investment certificates were not subordinated to the interests of creditors and were not permanent contributions to capital. 514 F.2d at 1207. These facts hold equal sway in the case of the Citizens merger. The Paulsens' interest in Citizens is not subordinated to the interests of Citizens' creditors or to anyone else. Their deposits are not permanent contributions to the capital of Citizens but instead, may be withdrawn (after one year) at will. Moreover, unlike the situation in *Home Savings*, under the Citizens merger agreement the Paulsens may borrow against their accounts at a rate even more favorable than that Citizens charges its other account holders. These factors persuade us, as they did our court in *Home Savings*, that the Citizens accounts are essentially the equivalent of cash.

Thus, were the interests acquired by the Paulsens identical to the withdrawable shares and investment certificates acquired by Home Savings, we would have no trouble whatsoever concluding that they should be classified as debt. The Paulsens point out, however, that their interests, unlike those at issue in *Home Savings*, are the only form of capital in the association. In *Home Savings*, Pasadena and Anaheim both had guarantee stock in their capital structure in addition to the withdrawable shares. Citizens, however, has no such stock. Its only owners are the depositors. This difference, the Paulsens claim, is critical. They make two arguments. First, they point out, the *Home Savings* panel stated that it "might be willing to weigh more heavily . . . (the) equity-like features (of the withdrawable shares and investment certificates) were there no greater equity-like interests involved." 514 F.2d at 1206. Second, they argue that to hold

the passbook accounts are debt would be to hold that no capital exists in Citizens at all, which, they claim, is of course not correct.

We find both arguments without merit. Though the *Home Savings* panel did indicate that it might be persuaded to classify the withdrawable shares and investment certificates as equity were they the only interests in existence, they were not. Thus the language cited by the Paulsens is dictum, and we have no reason to believe that the *Home Savings* panel ever seriously considered the question of what weight to give the fact that a particular interest is the only ownership interest in an association. Second, the Paulsens' argument simply misses the point. The argument that the passbook accounts are the only equity in Citizens and thus must be classified as equity for purposes of § 354 confuses the viewpoint of the corporation with that of the individual taxpayer. From the Association's point of view, there can be little doubt that the passbook accounts are equity in the sense that they represent the entire capital structure of the Association. This strikes us as irrelevant, however, as far as § 354 is concerned. The focus of that section is on the character of interests received from the point of view of the taxpayer, not that of the corporation. The critical question for purposes of § 354 is whether the position of the shareholder in the reorganized entity has really changed: has his risk increased or decreased? is his investment more or less liquid? If the position of the shareholder has changed to that of a creditor with ready access to his money then, regardless of the nature of his interests from the corporation's point of view, those interests cannot qualify as stock for purposes of § 354.

This is exactly what has happened in this case. Here, the Paulsens have exchanged their guaranty shares for passbook accounts and time certificates of deposit that, despite certain formal equity characteristics, are in reality indistinguishable

from ordinary savings accounts and are essentially the equivalent of cash. They have converted a risky investment into a risk-free one and a highly illiquid position into a highly liquid one. We see no reason why, under these circumstances, the gain they experienced by doing so should not be recognized.

This analysis finds support in *York v. Federal Home Loan Bank Board*, 624 F.2d 495 (4th Cir. 1980). There, the court was faced with the argument that the conversion of a mutual association into a stock savings and loan association had deprived depositors in the mutual of valuable property rights in the association in the form of rights to vote and to share in the proceed of any liquidation. Those rights were similar to those possessed by holders of Citizens passbook accounts and, in *York* too, the depositors argued that their interests had to be considered equity because they were the legal owners of the association. The Fourth Circuit, however, held that the interests of depositors had so little value as equity that they did not rise to the status of property rights. The court noted that

> [a]lthough the depositors are the legal "owners" of a mutual savings and loan, their interest is essentially that of creditors of the association and only secondarily as equity owners."

Id. at 499-500.

Thus, the Fourth Circuit held, the conversion of the mutual to a stock association would not deprive depositors of property rights because their "only actual rights, their rights as creditors of the association, will remain unchanged by the conversion." *Id.* at 500.

IV

We recognize that our decision conflicts with that reached by several other courts. In *Capital Savings and Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979),

the court held that a merger similar to that here, in which guaranty shareholders exchanged their shares for savings accounts in the acquiring mutual savings and loan association, was a tax-free reorganization. The court emphasised that savings accounts were the only form of equity in mutual associations. It stated that to conclude that such accounts constituted debt would be tantamount to saying that mutual savings and loan associations have no owners. Similar results were reached in *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974), and in *Everett v. United States* 448 F.2d 357 (10th Cir. 1971).

We are neither bound nor persuaded by those authorities. As noted above, we do not hold that a mutual savings and loan association is without owners. We merely hold that the interests at issue here, though they may be ownership interests for some purposes, do not "partake sufficiently of equity characteristics" to qualify this transaction as a tax free reorganization.[1]

REVERSED.

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[1]Though we do not assign the argument much weight, we agree with the Commissioner that serious administrative difficulties would result were we to affirm the Tax Court. The Paulsens would have in their passbook account and in each of seven separate time certificates a cash basis less than the actual dollar amount on deposit. Determining and taxing the gain each time a withdrawal is made would produce substantial accounting and administrative problems.

Judgment of the United States Court of Appeals for the Ninth Circuit.

United States Court of Appeals for the Ninth Circuit.

Harold T. and Marie B. Paulsen, Appellees, vs. Commissioner of Internal Revenue, Appellant, TAX# 17549-79. No. 82-7329.

JUDGMENT
WESTERN WASHINGTON

Upon Petition to Review a Decision of The Tax Court of the United States,

This Cause came on to be heard on the Transcript of the Record from The Tax Court of the United States, on April 5, 1983 and was duly submitted.

On Consideration Whereof, it is now here ordered and adjudged by this Court, that the Decision of the said Tax Court of the United States in this Cause be, and hereby is REVERSED.

Filed and entered August 16, 1983.

Text of Statutes and Regulations Involved.

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 354. Exchanges of Stock and Securities in certain Reorganizations.

(a) *GENERAL RULE* —

(1) *IN GENERAL* — No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * *

SEC. 368. Definitions Relating to Corporate Reorganizations.

(a) *REORGANIZATION* —

(1) *IN GENERAL* — For purposes of parts I and II and this part, the term "reorganization" means —

(A) a statutory merger or consolidation;

* * * *

SEC. 7701. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —

* * * *

(3) *CORPORATION* — The term "corporation" includes associations, joint-stock companies, and insurance companies.

* * * *

(7) *STOCK* — The term "stock" includes shares in an association, joint-stock company, or insurance company.

(8) *SHAREHOLDER* — The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

Code of Federal Regulations, Title 12, Part 544 (as in effect on July 1, 1976)

§ 544.1 Issuance of charter.

* * * *

(b) *Charter K. (rev.).* If expressly requested in the Petition for Charter, or in the Application for Conversion into a Federal association, the Board, in lieu of Charter N, will issue a Charter K (rev.), reading as follows:

* * * *

3. *Objects and powers.* The objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economical financing of homes; and, in the accomplishment of such objects, it shall have perpetual succession and power: . . . . (6) To raise its capital, which shall be unlimited, by accepting payments on savings accounts representing share interests in the association; . . . .

* * * *

No. 83-832

In the Supreme Court of the United States

OCTOBER TERM, 1983

HAROLD T. PAULSEN, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Section 354(a)(1) of the Internal Revenue Code generally provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation [which is] a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities • • • in another corporation [which is] a party to the reorganization." The question presented is whether the merger of a stock savings and loan association into a mutual savings and loan association, pursuant to which shareholders exchange their stock in the former for savings accounts in the latter, qualifies as a "reorganization" permitting tax-free, nonrecognition treatment of the gain realized on the exchange.

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COMMISSIONER OF INTERNAL REVENUE

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 20-32) is reported at 716 F.2d 653. The opinion of the Tax Court (Pet. App. 1-18) is reported at 78 T.C. 291.

JURISDICTION

The judgment of the court of appeals (Pet. App. 33) was entered on August 16, 1983. The petition for a writ of certiorari was filed on November 14, 1983. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Petitioners were shareholders of Commerce Savings and Loan Association (Commerce), a state-chartered, stock institution. On July 1, 1976, Commerce was merged into Citizens Federal Savings and Loan Association (Citizens), a federally-chartered, mutual institution (Pet. App. 22). Under the merger plan, each share of Commerce stock was

to be exchanged for a $12 deposit in a Citizens passbook savings account. Alternatively, Commerce shareholders could surrender their stock for Citizens certificates of deposit (CDs) at the same dollar exchange rate (Pet. App. 5, 22).

On July 1, 1976, petitioners owned 17,500 shares of Commerce stock with a tax basis, or cost, of about $57,000. In the merger exchange, they received Citizens savings accounts and CDs with a face amount of about $210,000 (Pet. App. 22). They thus realized a gain of $153,000. Petitioners did not report this gain as income on their 1976 tax return, taking the position that the merger was a "reorganization" and that the gain, accordingly, should not be currently recognized. Section 368(a)(1)(A) of the Code[1] defines "reorganization" to include "a statutory merger." Section 354(a)(1) provides that "[n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in * * * another corporation a party to the reorganization." Petitioners contended that the Citizens savings accounts they received in the merger were the functional equivalent of "stock," since Citizens was a mutual institution, and since those accounts represented ownership interests in it.

On audit, the Commissioner determined that the merger was not a tax-free reorganization, and that petitioners were required to recognize gain, taxable at capital gains rates, in the amount of $153,000—the difference between the value of the savings accounts they received and their basis in the Commerce stock surrendered (Pet. App. 1-6). It is well established that a merger qualifies as a "reorganization"

[1]Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as amended ("the Code" or "I.R.C.").

only if there is a "continuity of proprietary interest," *i.e.*, if the stockholders' ownership (equity) interest in the old corporation carries over to the new corporation, so that their position is substantially unchanged. *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *Le Tulle* v. *Scofield*, 308 U.S. 415 (1940); *Bazley* v. *Commissioner*, 331 U.S. 737 (1947). The ownership interest that the shareholders acquire in the new corporation, moreover, must be "definite and material" and must "represent a substantial part of the value of the thing transferred." *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935). The Commissioner took the position that petitioners received no meaningful ownership interest in Citizens when they acquired the savings accounts. He viewed those accounts as constituting, not "stock," but a "hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" (Pet. App. 10). The Commissioner concluded that these equity features were not sufficient to satisfy the "continuity of proprietary interest" test, and that petitioners in reality had exchanged their position as stockholders of Commerce for a position as creditors of Citizens.

Petitioners sought redetermination of the resulting deficiency in the Tax Court, which ruled against the Commissioner (Pet. App. 1-18). Following *Capital Savings & Loan Ass'n* v. *United States*, 607 F.2d 970 (Ct. Cl. 1979), *West Side Federal Savings & Loan Ass'n* v. *United States*, 494 F.2d 404 (6th Cir. 1974), and *Everett* v. *United States*, 448 F.2d 357 (10th Cir. 1971), the Tax Court held that the savings accounts received by petitioners were "stock" for purposes of the corporate reorganization provisions, and that the exchange was accordingly a tax-free reorganization (Pet. App. 10-17).

The court of appeals unanimously reversed (Pet. App. 20-32), following its earlier decision in *Home Savings & Loan Ass'n* v. *United States*, 514 F.2d 1199 (9th Cir.), cert.

denied, 423 U.S. 1015 (1975). The court acknowledged that the savings accounts carried with them certain proprietary features, since petitioners—like Citizens' other depositors and borrowers—thereby obtained technical voting rights and the (rather speculative) right to share in the proceeds of a solvent liquidation (Pet. App. 25-28). The court of appeals concluded, however, that the debt features of the savings accounts "overwhelmingly predominate[d]" (Pet. App. 24); that petitioners' interest in Citizens was essentially that of creditors; and that the savings accounts did not "partake sufficiently of equity characteristics" to satisfy the "continuity of proprietary interest" test (Pet. App. 27). In holding that the merger was not a tax-free reorganization, the Ninth Circuit "recognize[d] that [its] decision conflict[ed] with [those] reached by" the Court of Claims, the Sixth Circuit and the Tenth Circuit. *Id.* at 31-32, citing *Capital Savings & Loan, supra, West Side Federal Savings & Loan, supra*, and *Everett, supra.*

ARGUMENT

1. The court of appeals correctly held that the merger of Commerce into Citizens was not a tax-free reorganization, and that petitioners were not entitled to defer recognition of the gain they realized. The savings accounts petitioners received plainly did not constitute "stock" pure and simple. Rather, those accounts represented a hybrid interest possessing both debt and equity characteristics. Thus, in order to determine whether the merger entailed the "continuity of proprietary interest" requisite to a "reorganization" under this Court's decisions, it was necessary to inquire whether the savings accounts' equity features were "definite and material" and "represent[ed] a substantial part of the value" of the stock petitioners surrendered. Applying this test, the court of appeals properly determined that there was no

continuity of proprietary interest here. *Cf. Southwest Natural Gas Co.* v. *Commissioner*, 189 F.2d 332 (5th Cir.) cert. denied, 342 U.S. 860 (1951).

Although petitioners, as account holders in Citizens, technically possessed the rights to vote, to share in profits, and to participate in liquidation proceeds, those rights, viewed pragmatically in the context of a mutual savings and loan association, did not constitute a substantial proprietary interest. Citizens' borrowers, as well as its depositors, had the right to vote, but it could scarcely be contended that the former possessed any "proprietary interest" in the association. Depositors' voting rights were "infinitely dilutable" by the addition of new customers (Pet. App. 27), and in practice were surrendered to management when the accounts were opened (*ibid.*). Although depositors had a nominal right to participate in profits, through distributions that Citizens styled "dividends," Citizens in practice paid a fixed, preannounced rate on all accounts, so that accountholders' "profit participation" was illusory. The "dividends" Citizens distributed were identical to interest paid by stock institutions; indeed, elementary economics indicates that they must be, for "[i]t is fanciful to suggest that depositors deciding where to put their money attach any weight to whether an institution is a mutual or a stock association" (Pet. App. 27-28). The "dividends" were treated as interest for federal tax purposes, both from petitioners' and Citizens' points of view (I.R.C. §§ 116(c)(1), 591), and thus stood in marked contrast to the true dividends petitioners previously received on their Commerce shares (Pet. App. 28). Finally, while petitioners acquired a notional right to participate in the proceeds of any solvent liquidation of Citizens, the solvent liquidation of a savings and loan association is such a remote contingency that "any theoretical value [such a right might have] reduces almost to the vanishing point." *Society for Savings* v. *Bowers*, 349 U.S. 143, 150 (1955).

In sharp contrast to the minimal proprietary features of petitioners' savings accounts, the debt characteristics of those accounts were overwhelming. Petitioners obviously regarded the accounts—as one would regard any checking or savings account—as the equivalent of cash. The accounts, unlike the Commerce stock, were subject to withdrawal by petitioners and to retirement at the will of Citizens, and thus in no sense represented a permanent contribution to the latter association's capital. And whereas petitioners' stock investment in Commerce was "at risk"—a hallmark of a true equity stake—their investment in Citizens was essentially risk-free, being represented by short-term savings accounts that were federally insured.

In short, while petitioners clearly had an equity interest in Commerce, they just as clearly received a creditor's interest in Citizens. Far from continuing the proprietary ownership they previously had, they essentially cashed their investment out. Because the merger thus failed to satisfy the "continuity of proprietary interest" test, it was not a "reorganization" as defined by the statute or by this Court, and petitioners' exchange was properly treated as a sale of their Commerce stock producing currently taxable capital gain.

2. Common sense fully supports the court of appeals' construction of the Code's reorganization provisions, for any other interpretation would produce anomalous results. If the instant merger were a reorganization, petitioners would receive a "carryover basis" in their Citizens savings accounts, *i.e.*, a basis equal to their basis in the Commerce stock they gave up. See I.R.C. § 358(a)(1). Since petitioners' basis in their Commerce stock was $57,000, they would receive a basis of $57,000 in cash of $210,000. This result would violate the rule, uniform throughout the Internal Revenue Code, that cash, when expressed in U.S. currency, always has a basis equal to its face value. See, *e.g.*, I.R.C. §§ 301(b), 358(a)(2), 362(c).

This result would also create serious practical and administrative problems. Every time petitioners withdrew money from their passbook savings accounts, they would be required to recognize gain. Since each withdrawal would represent (on petitioners' theory) a redemption of "stock," the character of the gain—*i.e.*, whether a dividend taxable as ordinary income, or capital gain—would have to be determined by testing each withdrawal for "dividend equivalency" under the Code's elaborate redemption rules. See I.R.C. § 302. And every time petitioners deposited money into their passbook savings accounts, they would have to keep the "new cash" (which would have a basis equal to its face value) separate from the "old cash" (which would have a carryover basis), in effect dividing the passbooks into sub-accounts and creating severe tracing problems. These anomalies are not a mere awkwardness. Rather, they point up the logical shortcomings of a position that entails giving cash a tax basis different from its face value.

3. While we believe that the court of appeals was correct in holding that the merger of Commerce into Citizens was not a tax-free reorganization, we agree with petitioners (Pet. 8-13) and with the court of appeals (Pet. App. 31-32) that the decision below squarely conflicts with the decisions of the Court of Claims in *Capital Savings & Loan, supra*, the Sixth Circuit in *West Side Federal Savings & Loan, supra*, and the Tenth Circuit in *Everett, supra*.[2] The question presented, moreover, has considerable administrative

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[2]Of those three cases, only *Everett* involved the tax consequences of a comparable merger at the shareholder level. The other two cases involved the tax consequences of a comparable merger at the corporate level, such as restoration to income of a previously-established bad debt reserve. In each case, however, the fundamental issue was the same—whether the merger was a tax-free "reorganization." Parallel consequences for the corporation and its shareholders flow automatically from that determination. Compare I.R.C. §§ 354-358 with I.R.C. §§ 361-362.

importance. The Internal Revenue Service advises that at least 671 similar cases, involving approximately $20 million in income taxes, are pending administratively or in the lower courts. Accordingly, we do not oppose the granting of the petition for a writ of certiorari.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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JANUARY 1984

DOJ-1984-01

No. 83-832

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AMICUS CURIAE BRIEF OF CALIFORNIA LEAGUE OF SAVINGS INSTITUTIONS IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI TO THE U.S. COURT OF APPEALS FOR THE NINTH CIRCUIT.

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I

QUESTION PRESENTED

Does the sole form of direct equity ownership that a Federally chartered mutual savings and loan association can furnish to the stockholders of a stock savings and loan pursuant to a plan of reorganization within the meaning of Section 368(a)(1)(A) of the Internal Revenue Code, namely ownership of savings accounts in the Federal mutual savings and loan association, qualify for the tax-free exchange provisions of Section 354(a)(1) of the Internal Revenue Code?

II

INTEREST OF AMICUS CURIAE

The California Savings and Loan League ("California League") is a trade Association organized as a tax

exempt organization pursuant to Section 501(c)(6) of the Internal Revenue Code. Its membership consists of substantially all of the savings and loan associations, both stock and mutual, authorized to conduct business within the State of California. As of the final quarter of calendar 1983, there were approximately 250 such associations, of which about 150, with a total of approximately $165 billion in assets, were stock companies; and the remainder, with a total of approximately $25 billion in assets, were mutuals.

As explained in §III, infra, the opportunity for savings and loan associations to acquire other savings and loan associations through voluntary merger is essential to enable the savings and loan industry to accommodate

to changing circumstances and thus maintain economic viability. Yet unless the question presented is resolved in the affirmative, that opportunity will be needlessly curtailed.

III

ARGUMENT

A. The Question Presented Is Of Substantial Importance.

The savings and loan industry in the United States, composed of approximately 3,800 separate institutions with total assets of more than $700 billion, is a primary source of financial services for the American public. (U.S. League of Savings Institutions, Source book, (1983), pp. 36-37). Savings and loan associations

(most of the deposits of which are insured by an agency of the United States, the Federal Savings and Loan Insurance Corporation), in addition to the myriad of other services that they perform, are both depositories for the savings of millions of Americans and the largest source of residential real estate financing in the Nation. (U.S. League of Savings Institutions, Source book, (1983), p. 8. The operation of the savings and loan industry has significant ramifications for the real estate construction industry, the real estate sales industry, and the economy of the Nation as a whole. (U.S. League of Savings Institutions, Source book, (1983), p. 5).

One of the principal mechanisms employed by business entities

to adjust to changing circumstances is merger with other entities; and that mechanism has, historically, been of particular importance to the savings and loan industry.

The economic and technological environment in which savings and loan associations function has changed dramatically in recent years. Legally imposed ceilings on the interest rates that banks and savings and loan associations may pay depositors are in the process of being (and, indeed, largely have already been) phased out (see Depository Institutions Deregulation Act of 1980, sections 202(b), 204 and 205(a)); the range of services which savings and loan associations may provide has been greatly expanded (see generally 12 C.F.R. §545.1 et seq.);

savings and loan associations, previously confined for the most part to operating within a single state, have, under limited circumstances, been permitted to "go nationwide" by acquiring branches in multiple states (see Home Owners' Loan Act of 1933 as amended, section 5(r); 12 C.F.R. §556.5(a)(3)(ii)); and computerization has affected the way in which savings and loan associations deliver their services, including, for example, enabling them to provide services at locations remote from branches through so-called "remote service units" (see 12 C.F.R. §545.141(a)(3)).

Given such changes, a widespread reconfiguration of the industry through merger is taking place. Since 1980 alone, for example, more than one

thousand savings and loan associations, with assets in excess of one hundred and thirty four billion dollars, have been acquired by other associations (Kaplan Smith Report, September 1983, p. 2; published by Kaplan, Smith & Associates, Inc., 919 Eighteenth Street, N.W. Washington, D.C.) Moreover, it is obvious that the merger process is likely to be of continuing, and perhaps even accelerating, importance to the savings and loan industry in the foreseeable future.

Mergers may be structured as tax-free reorganizations within the meaning of §368(a)(1)(A) of the Internal Revenue Code in which an equity interest in the acquiring association is exchanged for the equity interest of the owners in the acquired association.

Indeed, although the League is not aware of any statistics to which it may cite in this regard, it is not unreasonable to assume that the vast majority of mergers that now take place are, and would not be economically feasible unless they could be, so structured.

While mergers may take place by a mutual association acquiring another mutual association, by a stock association acquiring another stock association, or by a stock association acquiring a mutual association, a fourth possibility is for a mutual association to acquire a stock association; and it is a possibility of obvious pragmatic significance. Of the approximately 3,800 savings and loan associations in the United States today, about 3,000, with assets of $486 billion, are mutual

associations (U.S. League of Savings Institutions, Source book, (1983), pp. 36-38).[1/] Moreover, in any given situation a large mutual association may, in economic terms be the most suitable (and perhaps the only) potential acquirer of a stock association.

The only direct equity interest which exists in a mutual savings and loan association, however, and thus the only equity interest available to the association to exchange for the stock of the acquired institution, is its savings accounts. Hence unless the exchange of savings accounts in a mutual association for stock in a

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1/ Until recently the entire federal savings and system was composed exclusively of mutual institutions. (See footnote 4, infra.)

stock association satisfies the requirements of §368(a)(1)(A), as a practical matter the acquisition by a federal association of a stock association through a direct exchange of equity would not be feasible; and, as a result, the universe of potential acquirers of stock associations through direct exchange of equity interests would be drastically diminished, to the detriment of the savings and loan industry, the

public that it serves, and, ultimately, the federal fisc itself. (See §III.C., infra.)[2/]

2/ While the acquisition of a stock association by a mutual association may theoretically be effected by other than a direct exchange of equity interests, such other transactions are often infeasible, either because of the tax consequences or for other reasons. If the acquisition of a stock association by a mutual association is treated as a taxable purchase of assets at the corporate level, rather than as an exchange of equity interests qualifying as a reorganization within the meaning of §368(a)(1)(A), the carryover provisions of §381 are inapplicable at the corporate level. In that event, severe additional tax liabilities would normally be incurred by both the acquired mutual and the acquiring stock association.

B. The Decision Of The United States Court of Appeals For The Ninth Circuit In Paulsen v. Commissioner, No. 82-7329, Has Engendered A Pernicious Uncertainty With Regard To The Proper Resolution Of The Question Presented.

Prior to the decision of the Ninth Circuit in Paulsen v. Commissioner, No. 82-7329 ("Paulsen"), the law was well established that transactions in which mutual savings and loan associations acquired stock savings

and loan associations through a direct exchange of equity interests were not precluded from constituting plans of reorganization within the meaning of Section 368(a)(1)(A) of the Internal Revenue Code merely because the equity interest given by the mutual association in exchange for the equity interest in the stock association was savings accounts in the acquiring institution. See Capital Savings and Loan Association v. United States, 607 F.2d 970 (Ct. Cl. 1979); West Side Federal Savings and Loan Association v. United States, 494 F.2d 404 (6th Cir. 1974); Everett v. United States, 448 F.2d 357 (10th Cir. 1971).

Paulsen, however, is contrary to the preexisting law and thus engenders doubt as to its continuing

viability, particularly within the jurisdiction of the United States Court of Appeals for the Ninth Circuit and other jurisdictions that have not yet passed on the question presented; and that doubt is, as a practical matter, likely to have the pernicious consequence of deterring future transactions of the type in question.

C. The Resolution Of The Question Presented By The United States Court Of Appeals For The Ninth Circuit In Paulsen Is Inimical To The Public Welfare And Therefore Contrary To Sound Public Policy.

The effect of the Paulsen decision is to preclude mutual savings and loan associations, both federally chartered and state chartered, from utilizing the tax deferral allowances of Internal Revenue Code §§ 368(1)(A) and 354(a)(1) in the acquisition of stock associations through the direct exchange

of equity interests and thus relegate such mutual associations to a disfavored tax status not shared either by stock savings and loan associations or corporations generally. That effect is inimical to the public welfare and, therefore, inconsistent with sound public policy. In particular:

1. As indicated in §III.A., supra, mergers are one of the principal mechanisms employed by the savings and loan industry to adjust to changing circumstances. Excluding mutual savings and loan from the opportunity to acquire stock associations through the direct exchange of equity interests drastically curtails merger opportunities for the savings and loan industry and, by so reducing the universe of potential acquirers, artifically distorts the

merger market. As a consequence, the value of the equity ownership of stock in associations is depressed to a level lower than that which would otherwise prevail; and, perhaps even more important, the incentive of stock associations to merge is reduced -- this even though merger may in a given situation, be the course best calculated to serve the public interest.

2. Mutual and stock savings and loan associations engage in the same activities and compete with each for the same business; and thus, in terms of their operations and in most basic respects, they are functional equiva-

lents.[3/] Yet since mutuals are unable to offer the owners of a stock association tax-free consideration for their equity interest, they are placed at a significant and functionally unwarranted

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3/ While there are differences between the operational powers of federal associations and the operational powers of state chartered associations of some states, the operational powers of a federal association are the same whether it is mutual or stock. (See Home Owners' Loan Act of 1933 As Amended, Section 2(d) and 12 C.F.R. §541.8 (defining a federal association), and Home Owners' Loan Act of 1933 As Amended, Section 5 and 12 C.F.R. §541 et seq. (specifying the powers of such an association).) Moreover, and although it lacks specific information in this regard, the League assumes that under most state laws the operational powers of stock and mutual associations are substantially the same.

disadvantage via-a-vis their stock competitors.[4/]

3. All federally chartered savings and loan associations, both stock and mutual, and the vast majority of state chartered savings and loan

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4/ Such a competitive disadvantage is particularly ironic in light of the fact that in 1954 when the pertinent Internal Revenue Code sections were enacted, all federally chartered savings and loan associations were mutual (see Depository Institutions Deregulation Act of 1980, section 404, allowing federally chartered stock associations for the first time); and federally chartered savings and loan associations are agencies and instrumentalities of the United States. (See, e.g., Federal Land Bank v. Bismarck Lumber Co., 314 U.S. 95, 102 (1941); United States v. State Tax Commission, 481 F.Supp 963, 969 (1st Cir. 1973); see also 12 C.F.R. §545.17). Indeed, Thus the Paulsen decision necessarily assumes that in enacting the pertinent Internal Revenue Code sections, Congress intended to place federal agencies and instrumentalities at a significant competitive disadvantage, vis-a-vis their nonfederal competitors -- a highly dubious assumption, to say the least.

associations, both stock and mutual, are insured by an agency of the United States, the Federal Savings and Loan Insurance Corporation; and there is a resolution of Congress to the effect that the federal treasury itself will "stand behind" the insurance obligations of that agency. (H. Con.Res. 290 (March 18, 1982); accord: S. Com. Res. 72 (March 24, 1982)). Hence, to the extent that troubled or potentially troubled stock institutions are deprived of merger opportunities, and these institutions subsequently fail or are merged only with the assistance of the Federal Savings and Loan Insurance Corporation, the risk to the Federal Savings and Loan Insurance Corporation,

and even the federal fisc itself, is gratuitously exacerbated.[5/]

IV

CONCLUSION

The question presented is important; the Paulsen decision has generated a pernicious uncertainty with regard to the resolution of that question which did not previously exist; and the resolution of the question presented in Paulsen is inimical to the

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5/ Indeed, since there are limits on the amount of insurance coverage provided by the Federal Savings and Loan Insurance Corporation for each account, &100,000 at present, the direct risk to memebers of the general public itself, in their capacity of depositors holding accounts in excess of $100,000, is also gratuitously exacerbated.

public welfare and therefore contrary to sound public policy.

The petition for writ of certiorari should be granted.

Respectfully submitted,

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On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Question Presented for Review.

Whether the merger of a state stock-type savings and loan association into a federal mutual savings and loan association, in which all the stock of the state association is exchanged for ownership savings accounts representing share interests in the federal mutual association, qualifies as a reorganization upon which taxable gain is deferred under sections 368(a)(1)(A) and 354(a)(1) of the Internal Revenue Code of 1954, as amended (the "Code").

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STATUTES AND REGULATIONS INVOLVED.

The relevant portions of sections 354, 368 and 7701 of the Internal Revenue Code of 1954, as amended (the "Code"), and of 12 C.F.R. § 544.1(b) as in effect on July 1, 1976, are set forth in the Appendix to the Petition for Certiorari at 34-35.

STATEMENT OF THE CASE.

The petitioners, Harold and Marie Paulsen, were shareholders of Commerce Savings and Loan Association of Tacoma ("Commerce") (Jt. App. 15). On July 1, 1976, pursuant to a Plan for

Merger, Commerce merged into Citizens Federal Savings and Loan Association ("Citizens Federal") (Jt. App. 15-16). In the merger, all the guaranty stock of Commerce, including that owned by the petitioners, was converted into Citizens Federal ownership accounts (Jt. App. 15-16, 63-64) "*representing share interests* in [Citizens Federal]." Charter K (Rev.) ¶ 3(6) (Jt. App. 37); 12 C.F.R. § 544.1(b) (1976) (Pet. Br. App. 35) (emphasis added). The petitioners received passbook and certificate share accounts (referred to as "Certificates of Deposit") with an aggregate face value of $209,508 in exchange for 17,459 shares of Commerce guaranty stock, in which they had a tax basis of $56,802 (Jt. App. 18).

Prior to the merger, Commerce was a Washington State chartered savings and loan association owned by the petitioners and the other holders of its guaranty stock (Jt. App. 14-15) (Pet. App. 3, n.2). Citizens Federal, the surviving entity, was and is a federal corporation chartered as a mutual savings and loan association under Charter K, Revised (Jt. App. 15, 36). Like all such corporations, it is owned exclusively by its share account holders. Charter K (Rev.) ¶¶ 3(6) and 10 (Jt. App. 37, 44-45); 12 C.F.R. § 544.1(b) (1976) (Pet. App. 35); 716 F.2d at 564 (Pet. App. 21). In the event of the liquidation or dissolution of Citizens Federal, its account holders are entitled to a pro rata distribution of its assets. Charter K (Rev.) ¶ 10 (Jt. App. 44-45).

On matters which require the approval of the members of the association, each holder of a Citizens Federal account is entitled to one vote for every $100 (or fraction thereof) of the amount invested in his account, up to a maximum of 400 votes. A borrower from Citizens Federal is regarded as a *non-proprietary member* and is accorded one vote. Charter K (Rev.) ¶ 4 (Jt. App. 38-39).

Citizens Federal's charter and bylaws provide that twice each year its net earnings and any surplus are to be distributed to account holders on a pro rata basis. All distributions on accounts are expressly dependent upon the financial success of the association and are made only out of profits of the enterprise, ratably according to the size of the investment. Charter K (Rev.) ¶ 10

(Jt. App. 43-44). The amount of the distribution, if any, is determined and declared periodically by the Board of Directors, subject to regulatory limitations in effect at the time. Charter K (Rev.) ¶ 10 (Jt. App. 43-44). If the association is not profitable or its reserves or surplus are too low, no distribution will be made on any account, and the association is liable for none. *See* Charter K (Rev.) ¶ 10 (Jt. App. 43-44); 12 C.F.R. § 563.14 (1976) (Pet. Br. App. 4).

Under the terms of its charter, Citizens Federal will honor written requests to withdraw from the association by its account holders within thirty days, so long as funds are available to honor the redemption requests without jeopardizing the financial well-being of the institution. If the association is unable to pay all withdrawal requests within 30 days, it will institute a revolving system, paying withdrawal requests of up to $1000 in the order received to the extent that receipts exceed the amount required for normal operations. Charter K (Rev.) ¶ 6 (Jt. App. 40). Citizens Federal's charter specifically provides that "[*h*]*olders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid and shall not become creditors.*" Charter K (Rev.) ¶ 6 (Jt. App. 41) (emphasis added).

Its charter also gives Citizens Federal the right, under certain specified circumstances and when there would be no impairment of capital, to redeem accounts, by lot or otherwise as the Board of Directors may determine. The redemption price must be "the full value" of the account, but may not be less than the account holder would receive if he withdrew from the association. Charter K (Rev.) ¶ 7 (Jt. App. 41-42).

The accounts issued by Citizens Federal in the merger had the same rights as all other Citizens Federal share accounts, but were subject to a withdrawal restriction of at least one year (Jt. App. 17). In the merger agreement, Citizens Federal agreed to make loans to the former Commerce shareholders against the security of their accounts at a slightly lower interest rate (0.5% less) than that it normally charged its account holders for similar loans (Jt. App. 18).

On audit of the petitioners' 1976 federal income tax return, the Commissioner asserted a deficiency based on his determination that petitioners were required to recognize gain in 1976 in an amount measured by the difference between their adjusted tax basis in the Commerce guaranty stock they surrendered in the merger and the face value of the Citizens Federal share accounts they received (Jt. App. 14) (Pet. App. 6). He issued a statutory notice of deficiency, and the petitioners filed a petition in the United States Tax Court for redetermination of the asserted deficiency (Jt. App. 3, 14). They contended that the merger was a reorganization of the two savings and loan associations within the meaning of section 368 of the Code and that recognition of any gain they realized on the exchange was therefore deferred by Code section 354(a)(1) until such time as they withdrew or otherwise disposed of the Citizens Federal accounts they received in the merger (Jt. App. 3-4) (Pet. App. 6).

The Tax Court, in an opinion by Judge Featherston, agreed with the petitioners. It held that the merger was a reorganization under section 368(a)(1)(A) of the Code and that, accordingly, the petitioners recognized no gain or loss on their exchange by virtue of section 354(a)(1). A decision was entered in the petitioners' favor on March 8, 1982. *Paulsen v. Commissioner*, 78 T.C. 291 (1982) (Pet. App. 1-18).

The Commissioner appealed the Tax Court decision to the Court of Appeals for the Ninth Circuit. The Ninth Circuit, departing from a substantial body of precedent, reversed the Tax Court. The court of appeals concluded that a merger of a stock-type savings and loan association into a mutual savings and loan association does not constitute a reorganization exempt from recognition of gain or loss under the Code. 716 F.2d 563, 564, 569 (1983) (Pet. App. 20, 31-32).

SUMMARY OF ARGUMENT.

The reorganization provisions of the Code provide a comprehensive series of definitions which must be met in order to defer the recognition of gain or loss on the transfer of property or stock in a corporate combination or restructuring. In addition to the literal compliance with the statute, however, the transaction must

also not be subject to certain judicially imposed limitations. These judicial limitations have been broadly classified as the "business purpose" and "continuity of proprietary interest" doctrines. B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.03 (4th ed. 1979). If the transaction meets the statutory requirements and is not subject to these judicial limitations, a corporation recognizes neither gain nor loss on the transfer of its property for stock or securities in another corporation that is a party to the reorganization, and the shareholders may exchange their stock or securities for new instruments without recognizing gain or loss. The "tax cost" imposed by the Code for a reorganization is a carry-over adjusted basis in the property or stock transferred or exchanged. Thus, the gain or loss that went unrecognized at the time of the exchange will be recognized when the property is subsequently sold or the investment liquidated. The issue in this case is the proper application of the judicial "continuity of proprietary interest" limitation which has been developed by this Court in a series of cases. *E.g.*, *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935).

When the petitioners exchanged their stock in a state savings and loan association for share interests in a federal mutual savings and loan association, the transaction complied with the statutory requirements for a reorganization. The Code explicitly states that an association is a corporation, a share in an association is stock, and a member in an association is a shareholder. I.R.C. § 7701(a)(2), (3), (7) & (8). Thus, before the exchange the petitioners were shareholders in a corporation, and after the exchange they were shareholders in a corporation. Their investment remained in corporate solution and they continued their old investment in the new combined enterprise.

The continuity of proprietary interest doctrine requires that the petitioners retain a continuing interest in the reorganized corporation. The respondent's position, accepted by the Ninth Circuit Court of Appeals below, requires a *comparison* of the ownership

interest exchanged with the ownership interest received. Because the respondent and the Ninth Circuit found the relationship of the petitioners to the reorganized corporation had changed, they concluded that gain had to be recognized. The cases decided by this Court, however, make it clear that the inquiry is not whether the shareholders of a merged corporation received a larger or smaller or different kind of proprietary interest than they surrendered, but whether a proprietary interest was received. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935). Since a mutual association's account holders are its stockholders and its only owners, they by definition have a definite and substantial proprietary interest in its affairs.

The petitioners' share interests in the surviving federal mutual savings and loan association are represented by passbook and certificate accounts. While such accounts may in some ways resemble bank deposits, the inquiry cannot stop at that superficial level. The respondent has admitted and the Ninth Circuit Court of Appeals found that the account holders of a federal mutual savings and loan association hold all of the proprietary rights and interest in the association. The charter and bylaws of Citizens Federal also make it clear the account holders have substantial rights as owners of the association. These include the right to vote, elect the Board of Directors, receive financial reports and approve major changes in policy and organization.

Equally indicative of their proprietary interest in the association is the fact that Citizens Federal's account holders share pro rata in the increase or decrease in value of its net assets which would be realized upon liquidation of the association or acquisition by another corporation. The account holders are also dependent upon the profitability of the association for any return on their investment, because they can only receive dividends from the profits of the enterprise, which must first be declared by the Board of Directors. Charter K (Rev.) and Bylaws (Jt. App. 36-53). *Cf. Tcherepnin v. Knight*, 389 U.S. 332 (1967).

The legislative history of the applicable Code provisions demonstrates that the types of instruments that may be received in a

reorganization are not limited to what is commonly referred to as "stock." The definitions of "stock" to include shares in an association and of "corporation" to include associations have been in the Code for many years and have been repeatedly reenacted by Congress. There is no indication whatsoever that federal mutual associations such as Citizens Federal were to be excluded from the reorganization sections of the Code.

For many years, reorganizations such as the one in issue took place with the respondent's blessing. Not until the mid-1960's did the respondent reverse his position on the issue presented in this case. Yet there has been no change in the law.

While it is conceded that the Commissioner has the right to change his position, that change must be based on a logical interpretation of the law. The Commissioner's published ruling holds that there can be a reorganization between two mutual savings and loan associations under the Code. Rev. Rul. 69-3, 1969-1 C.B. 103. Presumably in that ruling the reorganization met both the literal language of the Code and the judicially imposed limitations, so that the shareholders of the merged mutual association had a continuing proprietary interest in the reorganized entity. Yet the Commissioner in the same breath concluded that the merger of a stock-type association into a mutual association is not a reorganization. Rev. Rul. 69-6, 1969-1 C.B. 104.

In his rulings, the Commissioner has ignored the decisions of this Court and has instead examined whether the proprietary interest received has changed compared with the proprietary interest surrendered, rather than whether a proprietary interest in the ongoing enterprise *was in fact* received. This leaves the respondent in the untenable position of contending that share accounts are equity interests for some reorganizations but not for others. The Code and judicial decisions make no such distinction.

The issue in this case has been considered by a number of courts in the past and each has rejected the respondent's position. Those cases relied on the decisions of this Court and held there *can* be a reorganization involving the merger of a stock-type savings and loan association into a mutual savings and loan association. Each of the courts, in a well-reasoned opinion, held

that the continuity of proprietary interest test was satisfied. It is submitted that these courts properly applied the test, whereas the respondent and the Ninth Circuit Court of Appeals below did not. *See Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Owens v. Commissioner*, T.C. Memo. 1983-302 (May 26, 1983); *Paulsen v. Commissioner*, 78 T.C. 291 (1982); *Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980).

Even more disturbing than the immediate tax impact on the petitioners, however, is that the position of the respondent and the decision by the court of appeals below unduly interfere with legitimate business combinations and discriminate against mutual savings and loan associations in favor of stock-type savings and loan associations. Based on the Code and judicial decisions, there is no reason why a mutual association should not be able to compete with a stock-type savings and loan association for the acquisition of a stock-type association. Yet unless this issue is resolved in favor of the petitioners, a stock-type association and its shareholders would incur an immediate tax if the association were acquired by a mutual association while, on the other hand, they could enter into a reorganization with another stock-type association. The result is that a mutual association would not be able to acquire a stock-type association or would have to pay an additional amount to compensate for the immediate tax impact. There is no evidence that Congress ever intended to discriminate in such a manner against mutual savings and loan associations. To the contrary, every indication is that Congress has sought to encourage the savings and loan industry.

In addition, the test adopted by the Ninth Circuit Court of Appeals affects *all* reorganizations. If followed, it would require courts to examine the interest received in each reorganization to see if it has really changed from the interest surrendered. That

is not the test that has been established by this Court and long relied upon by taxpayers. To avoid this unnecessary confusion and unfairness, the decision below must be reversed.

ARGUMENT.

I.

THE CONVERSION OF COMMERCE STOCK INTO CITIZENS FEDERAL SHARE ACCOUNT INTERESTS ON THE MERGER OF COMMERCE INTO CITIZENS FEDERAL WAS A STOCK-FOR-STOCK EXCHANGE IN PURSUANCE OF A PLAN OF REORGANIZATION WITHIN THE MEANING OF SECTIONS 368(a)(1)(A) AND 354(a)(1) OF THE CODE RESULTING IN NO CURRENT GAIN OR LOSS ON THE EXCHANGE.

This case is one in a series of attacks by the respondent over the last fifteen years, challenging bona fide reorganizations involving a guarantee stock-type savings and loan association and a mutual savings and loan association where the mutual association is the surviving entity. *E.g.*, *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980). Each of these cases was decided adversely to the respondent.

The United States Tax Court in its decision below thus joined an unbroken line of authority rejecting the respondent's contention that the exchange by a mutual savings and loan association of its share accounts for all the guarantee stock of a stock-type savings and loan association pursuant to a statutory merger of the two business entities does not constitute a reorganization. The issue was so well-settled that the respondent, after losing in *Capital*, decided not to litigate it further "at the corporate level." See Action on Decision No. CC-1981-99, at 2. Yet, in the instant case, and in many others pending in the lower courts, he has

continued to refuse reorganization treatment to the shareholders in the same type of transaction while fully recognizing that any distinction between the tax treatment of the corporation and its shareholders is untenable. As the respondent conceded in his response to our Petition for Certiorari: "[p]arallel consequences for the corporation and its shareholders flow automatically from [the] determination [that a merger of the type in issue is a reorganization]." Resp. Br. on Pet. at 7, n. 2.

On appeal of this case to the Ninth Circuit, the respondent finally prevailed on his contention that a merger of a stock-type savings and loan association into a mutual savings and loan association does not come within the reorganization provisions of the Code. To reach that result, the court of appeals had to create and apply a version of the "continuity of proprietary interest" test contrary to the principles enunciated by this Court. Both the respondent and the Ninth Circuit recognized that the holding below is in direct conflict with the decisions of all the other courts which found a qualifying reorganization on substantially identical facts.

A. The Decisions of This Court Make It Clear That a Bona Fide Combination of Both the Corporate Ownerships and the Business Operations of Two Entities Within the Literal Terms of the Code Will Qualify as a Reorganization Upon Which No Gain or Loss Is Currently Recognized.

This Court has, on at least 11 occasions, been called upon to determine whether a particular transaction qualified under the then applicable revenue acts as a "reorganization" upon which gain or loss was not recognized.[1] In its decisions, the Court has

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[1] *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Bazley v. Commissioner*, 331 U.S. 737, *reh'g denied*, 332 U.S. 752 (1947); *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940); *United States v. Hendler*, 303 U.S. 564, *reh'g denied*, 304 U.S. 588 (1938); *Groman v. Commissioner*, 302 U.S. 82, *reh'g denied*, 302 U.S. 779 (1937); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Helvering v. Watts*, 296 U.S. 387 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

instructed that, to be characterized and taxed as a reorganization, the transaction in question must (i) come within the language of the act; and (ii) effect a bona fide restructuring or readjustment of the ownership and business operations of the entity or entities involved. This Court has never denied a transaction reorganization treatment where both of the foregoing requirements are met.

1. The Transaction at Issue Comes Within the Literal Terms of the Code.

Section 368 of the Code, which sets forth the types of corporate transactions that constitute a "reorganization," includes within the meaning of that term "a statutory merger or consolidation." I.R.C. § 368(a)(1)(A). In conjunction with section 368, Code section 354 provides that

> [n]o gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

I.R.C. § 354(a)(1). Congress defined the term "corporation" in the Code to include an association, the term "stock" to include "shares in an association" and the term "shareholder" to include a "member in an association." I.R.C. § 7701(a)(3), (7) & (8).

By their express terms, these Code sections apply to the transaction at issue in this case. The petitioners exchanged stock for "shares in an association" in "pursuance of the plan of reorganization," a statutory merger. A literal reading of the Code therefore exempts the petitioners' exchange from recognition of gain or loss, but the Ninth Circuit declined to apply the plain language of the Code.

2. The Only Issue in This Case Is Whether the Merger Satisfied the Continuity of Proprietary Interest Test.

The requirement that a transaction, to qualify as a reorganization, must effect a bona fide restructuring of both the business ownership and operations of the entities involved is not found within the language of the Code. Instead, it is a judicially evolved prerequisite intended to assure that transactions which are tech-

nically encompassed within the literal terms of the statute, but do not fulfill its purpose, will not receive reorganization treatment. It recognizes, however, that Congress intended to encourage valid business readjustments or combinations by deferring taxation on such transactions until the owners of the enterprises actually withdraw their investment in the business assets, "even if the property received in exchange has a readily realizable market value." S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (discussing the Revenue Act of 1921).

Where the business operations of the entities involved are continued after the transaction, this Court has enunciated only two exceptions to reorganization treatment for transactions otherwise within the plain language of the statutes. The first, which is directed at tax-avoidance devices undertaken for no real business purpose, is set forth in the landmark reorganization case of *Gregory v. Helvering*, 293 U.S. 465 (1935). The Court there held that "an operation having no business or corporate purpose — a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business or any part of a business, but to [make a tax-free dividend of property to the taxpayer]," lay "outside the plain intent of the statute." *Id.* at 469-70.

The instant case stands in stark contrast to *Gregory*. In *Gregory*, a sole shareholder had devised a scheme structured in form as a reorganization in an effort to avoid dividend treatment on the distribution to her of certain stock owned by the corporation, whereas here, two unrelated ongoing business entities have joined together for the mutual benefit of both and continued to operate as one enterprise with the same original owners. Unlike the transaction in *Gregory*, the merger of Commerce into Citizens Federal served all the corporate purposes of a reorganization. The respondent has never contended that it was a scheme to avoid tax. Without question, the transaction at issue was a "bona fide business move" which the "details of corporate affairs" reveal accomplished far more than tax deferral, and therefore does not come within the *Gregory* exception. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

The second exception to reorganization treatment has been developed by this and other courts to separate pure sales from true business readjustments. It applies to transactions structured in form as reorganizations but in which the owners of the acquired entity have not retained a material proprietary interest in the reorganized enterprise. That is, they have not continued as owners of the business. In cases where such continuity of proprietary interest does not exist, the courts have found the transaction to be nothing more than a sale and have denied reorganization treatment to both the corporations and the shareholders involved. Thus, in *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940) (receipt of debt securities, and no stock) and *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (receipt of cash and short term promissory notes) the Court held there was not a reorganization. On the other hand, in *Helvering v. Watts*, 296 U.S. 387 (1935) (receipt of stock and mortgage bonds), *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935) (receipt of cash and voting trust certificates representing common stock) and *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (receipt of consideration comprised 38 percent of nonvoting preferred stock and the rest cash) this Court found valid reorganizations.

Except for the decision of the court of appeals below, every court that has applied the continuity of proprietary interest test to the merger of a stock-type savings and loan association into a mutual savings and loan association has found the test satisfied and has therefore upheld the transaction as a reorganization. The petitioners submit that the decision of the Ninth Circuit is in direct conflict with this Court's (i) interpretation of the Code provisions governing reorganizations, and (ii) characterization of the nature of an account holder's legal interest in a mutual savings and loan association.

B. The Ninth Circuit Erred in Its Interpretation of the Continuity of Proprietary Interest Test as Enunciated by This Court.

The continuity of proprietary interest test as defined by this Court in varying factual situations and applied by other courts over the years has been summarized by the Court of Appeals for

the Fifth Circuit in the following often-quoted passage:

> While no precise formula has been expressed for determining whether there has been retention of the requisite interest, it seems clear . . . [there must be] a showing: (1) that the transferor * * * or its shareholders retained a *substantial proprietary stake* in the enterprise represented by a *material interest* in the affairs of the transferee corporation, and, (2) that such *retained interest* represents a *substantial part of the value* of the *property transferred*.

Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

This Court has held that the interest in the affairs of the surviving entity which is received by the acquired corporation's shareholders must be "more definite than . . . ownership of its short-term purchase money notes" and that the test is not satisfied if the sole consideration received by those shareholders consists of securities, regardless of their term. *Minnesota Tea Co.*, 296 U.S. at 385 [quoting *Pinellas Ice & Cold Storage Co.*, 287 U.S. 462 (1933)]; *Le Tulle v. Scofield*, 308 U.S. at 420-21. In such cases, the transaction is nothing more than a sale and does not "partake of the nature of a [reorganization]." By contrast, voting trust certificates representing common stock, or nonvoting preferred stock which is redeemable at stated intervals and has no voice in the control of the corporation except on default of dividend payments, will satisfy the test. *Minnesota Tea Co.*, 296 U.S. at 381, 386; *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 376-77 (1935). Therefore, the instrument conveying the requisite proprietary stake in the enterprise must represent an equity interest in the transferee corporation, and that type of instrument must be received in exchange for "a substantial part of the value" of the stock, securities or assets transferred.

Although the Ninth Circuit briefly referred to certain of the foregoing principles, it applied an incorrect standard to the facts before it in this case. It stated that the "*critical question*" in determining if a reorganization has occurred is "*whether the position of the shareholder in the reorganized entity has really changed: has his risk increased or decreased? is his investment more or less liquid*?" 716 F.2d at 569 (Pet. App. 30) (emphasis added). The court of appeals then concluded that, although the petitioners had remained owners of the surviving association, they had "converted a risky investment into a risk-free one and a highly illiquid position into a highly liquid one." "[U]nder [those] circumstances," the court of appeals said, it "[saw] no reason why . . . the gain they experienced by doing so should not be recognized." *Id.* (Pet. App. 31).

The "reason," the petitioners respectfully submit, is that the statute and case law provide otherwise. This Court has repeatedly rejected the requirement, urged by the respondent and imposed by the Ninth Circuit, that the relationship of the shareholders of the acquired corporation to the assets conveyed cannot be "really changed." In *Minnesota Tea*, where the acquired corporation's shareholders received voting trust certificates representing common stock worth approximately $540,000 and an additional $425,000 in cash from the acquiring corporation, the Commissioner also argued that the transaction did not qualify as a reorganization because it "substantially changed the relation of the taxpayer to its assets. . . ." 296 U.S. at 384. This Court responded:

> The transaction here was no sale, *but partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser*.
>
> *True it is that the relationship of the taxpayer to the assets conveyed was substantially changed, but this is not inhibited by the statute*. Also, a large part of the consideration was cash. This, we think, is permissible so long as the taxpayer received an interest in the affairs of the transferee which represented a material part of the value of the transferred assets.

Id. at 386 (emphasis added).

Similarly, in *John A. Nelson Co.*, 296 U.S. at 377, the acquired corporation's shareholders received only *nonvoting* preferred stock of the acquiring corporation, plus cash. Reversing the Tax Court's conclusion that no reorganization had occurred, this Court noted that the owner of preferred stock (even nonvoting, redeemable preferred) "is not without substantial interest in the affairs of the issuing corporation. . . ." *Id.* at 377. Accordingly, the Court

refused to deny reorganization status to the transaction simply because the nature of the proprietary interest retained by the acquired corporation's shareholders in the reorganized enterprise had substantially changed in relation to the ownership interest they had held in the acquired corporation. *Id.* at 377.

The respondent's published rulings demonstrate that it is his position, the position now endorsed by the Ninth Circuit, that the nature of the interest received by the petitioners is not controlling, but that it is the perceived degree of change in the proprietary interest received that is controlling. For example, the Commissioner has ruled publicly that accounts in mutual savings and loan associations constitute "stock" if exchanged for other savings accounts or for the stock of a guaranty stock-type association; yet these same accounts are not "stock" if received in exchange for guaranty stock. *Compare* Rev. Rul. 69-3, 1969-1 C.B. 103 (merger of two mutual savings and loan associations constitutes an "A" reorganization) and Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of a mutual savings and loan association into a guaranty stock-type savings and loan association is a tax-free reorganization) *with* Rev. Rul. 69-6, 1969-1 C.B. 104 (merger of a guaranty stock-type association into a mutual association constitutes a "sale of assets" and not a reorganization within the meaning of section 368(a)(1)(A)). There can be no doubt, therefore, that the Commissioner seeks to tax what he views as a change in the nature of the proprietary interest, as precluded by the decisions of this Court.

That the court of appeals in fact reached its conclusion based on what it perceived as differences between the ownership interest relinquished by the petitioners and the ownership interest they received in Citizens Federal is evidenced by its refusal to give any weight whatsoever to the actual legal rights which define the equity nature of a Citizens Federal share account. For instance, the court of appeals summarily dismissed the account holders' right to vote, because it found "the voting rights received by Citizens depositors are quite dissimilar to those of holders of equity interest in other corporations." 716 F.2d at 567 (Pet. App. 27). In the same vein, the appeals court stated that "though

Citizens does indeed distribute what it calls 'dividends,' " it "pays a fixed, preannounced rate on all accounts." From this the Ninth Circuit concluded that the dividends are "in practice" [although not in legal reality] . . . identical in all essential respects to the interest paid by stock savings and loan associations [on nonproprietary deposits]." *Id.* at 567 (Pet. App. 27).

The appeals court also attached no weight to the fact that Citizens Federal's account holders own all the underlying assets of the association. At the same time, it freely admitted that, "[f]rom the Association's point of view, *there can be little doubt that the passbook accounts are equity* in the sense that they represent the entire capital of the Association." *Id.* at 569 (Pet. App. 30) (emphasis added). This the Ninth Circuit found "irrelevant" to its determination of whether the transaction constituted a "reorganization." (Pet. App. 30).[2]

The absurdity of the test used by the Ninth Circuit is readily apparent when applied to other bona fide reorganizations, because the degree of risk or liquidity of a share of stock in the acquired corporation is rarely exactly comparable to that of a share of stock in the acquiring entity. In a closely held corporation, for example, the stock may be virtually unsaleable unless offered in an entire controlling bloc, whereas a shareholder in a corporation such as IBM can liquidate his investment in a few seconds merely by placing a call to his broker. Yet no court has ever held that a merger of such dissimilar entities would not qualify as a reorganization.

In sum, the court of appeals in this case chose to ignore the fact that the share accounts received by the petitioners *are equity* and instead focused its analysis exclusively on the *change* be-

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[2]Based on the analysis set forth in its opinion, the court of appeals would apparently not consider an exchange of common stock for normal preferred stock, including that issued in *John A. Nelson Company*, 296 U.S. 374, to come within the reorganization provisions of the Code. After all, such stock generally has *no* voting rights, pays a stated, fixed rate of dividends, is entitled to receive only its par (paid-in) value upon liquidation, and is usually redeemable after a period of time or under certain circumstances.

tween the equity interest given up and the equity interest received. Under the standards developed by this Court, which have been consistently applied for years by the lower courts, the transaction at issue cannot be denied reorganization treatment simply because the risk and liquidity of the proprietary interest held by the shareholders of the acquired association in the reorganized enterprise may have "really changed." The question to be decided is whether those shareholders in fact continued as owners of the business. If that question is answered in the affirmative, as even the Ninth Circuit conceded it must be, the petitioners and other former Commerce shareholders "acquired a definite and material interest in [Citizens Federal] represent[ing] a substantial part of the [stock] transferred," and their transaction therefore "partook of the nature of a reorganization." *Minnesota Tea Co.*, 296 U.S. at 385-86; *Pinellas Ice & Cold Storage Co.*, 287 U.S. at 469.

C. Citizens Federal's Savings Share Accounts Are Equity Interests Which Satisfy the Continuity of Proprietary Interest Test.

1. The Charter and Bylaws of Citizens Federal Establish That Its Account Holders Are the Sole Owners of the Association and That Its Accounts Represent an Equity Interest in the Association.

The respondent has admitted and the Ninth Circuit Court of Appeals has found that Citizens Federal's account holders hold all the proprietary rights and interest in the association (except for a nominal vote granted borrowers). They are the sole owners of its assets. Brief for the Appellant on Appeal to the Ninth Circuit Court of Appeals at 3-4; 716 F.2d at 564 (Pet. App. 21, 30).

As a corporation chartered by the federal government under Charter K (Revised), Citizens Federal raises its capital in the only permissible form: by accepting payments on accounts which "*represent share interests in the association.*"[3] Charter K (Rev.)

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[3]Both the Commissioner and the Ninth Circuit attach considerable weight to the current popular use of terms such as "interest" and "depositor" to describe what traditionally were accurately denominated "dividends" and "shareholders." They also assert, without discussing

¶ 3(6) (Jt. App. 37) (emphasis added). The only way to become an equity owner in Citizens Federal is to become the holder of such a share interest, or savings account, just as the only way to become an equity owner of any corporation is to become the holder of its stock. Like ordinary stock certificates, the passbooks or certificates representing these accounts are not negotiable, but are, upon request, transferable on the books and records of the association. 12 U.S.C. § 1464(b)(1) (1976).

Citizens Federal account holders also have all the rights normally associated with stockholders. Except for the one vote each accorded borrowers, they have the full voting power, and thus the ultimate control over the association. Charter K (Rev.) ¶ 4 (Jt. App. 38). Like typical shareholders, they elect the Board of Directors, receive full annual financial reports on the association, can amend its charter and bylaws, and have the right to approve major changes of policy and organization. Charter K (Rev.) ¶¶ 5, 11 (Jt. App. 39, 45); Bylaws ¶¶ 1, 11 (Jt. App. 45-46, 51-52); *see* 12 C.F.R. §§ 546.4 and 546.5 (1976) (Pet. Br. App. 1-3); *see also* 12 C.F.R. § 546.2(e) (1983). Only members of the association are eligible to become or remain directors. Charter K (Rev.) ¶ 5 (Jt. App. 39).

As its equity owners, Citizens Federal's account holders are the sole beneficiaries of any increase in value of its net assets.

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the underlying rights and characteristics of the accounts, that the "practice" of making regular distributions of earnings makes the right to share in profits "illusory" and converts the distributions into interest. Brief for Appellant on Appeal to the Ninth Circuit Court of Appeals at 16, n. 8; 716 F.2d at 567-68 (Pet. App. 27-28). Taken to its logical extension, that argument would make the right to share in profits of preferred stockholders in most successful corporations "illusory." It is, of course, the actual legal rights of the account holders which must control the outcome of this case, not the terminology that the respondent, the Federal Home Loan Bank Board or even the associations themselves have chosen to use. *Gregory v. Helvering*, 293 U.S. 465 (1935). Furthermore, ignorance or misconceptions on the part of account holders or the public in general are not grounds for treating the fundamental legal relationship between an association and its owners as other than it really is. *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714, 717 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961), *reh'g denied*, 368 U.S. 979 (1962).

They are entitled to share equally, on a pro rata basis according to the investment in their accounts, in the residual assets of the association upon its liquidation (Charter K (Rev.) ¶ 10 (Jt. App. 44-45)), and they have the power, subject to Federal Home Loan Bank Board ("FHLBB") approval, to cause Citizens Federal to be liquidated and dissolved. 12 C.F.R. § 546.4 (1976) (Pet. Br. App. 1-2). *Nor is this mere theory*, for such liquidations have in fact occurred,[4] and liquidation surpluses exist even where the association is in receivership and the liquidation is involuntary. *See, e.g., Lanigan v. Apollo Savings*, 52 Ill. 2d 342, 288 N.E. 2d 445, 448 (1972) (involving a state stock-type association). Similarly, Citizens Federal's account holders would realize the increased value of their investment if their corporation were acquired by another. *See, e.g.*, Rev. Rul. 69-646, 1969-2 C.B. 54 (merger of a mutual savings and loan association into a guaranty stock-type association wherein each shareholder in the mutual association received guaranty shares which had a fair market value equal to his pro rata interest in the undivided profits and reserves of the mutual association on the date of the exchange).[5] *Id.* at 55.

Although federal law and Charter K (Revised) *permit* it to raise an unlimited amount of capital, Citizens Federal's bylaws contain provisions to protect its owners if acceptance of additional capital would jeopardize or diminish their interests. The Board of Directors may "limit payments on capital which may be accepted"

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[4]*See* Russell, *Savings and Loan Associations*, 98 (2d ed. 1960) (reporting that "numerous" voluntary liquidations occurred at or above par from 1930 to 1954); *see also Federal Home Loan Bank Board v. Elliott*, 386 F.2d 42, 45 (9th Cir. 1967), *cert. denied*, 390 U.S. 1011 (1968) (anticipated liquidation surplus of Long Beach Federal Savings and Loan Association, which eventually merged with state guarantee stock association rather than liquidate).

[5]The respondent treated the merger as a reorganization within the meaning of section 368(a)(1)(A) of the Code and held that section 354 prevented recognition of gain or loss by the former shareholders of the mutual association on the disposition of their passbook and certificate accounts, *despite* the fact that nonproprietary deposits in the stock-type association were also received in the merger.

or "reject any application for savings accounts or membership" when it becomes in the best interests of the association and its members. Bylaws ¶ 7(e) & (f) (Jt. App. 50). This authority can be exercised, for instance, to protect against "insider trading" that might dilute the interests of the holders of accounts already issued and outstanding in the net worth of the association if a merger or liquidation is anticipated.[6]

Citizens Federal account holders likewise share ratably in any decrease in the value of the association's assets and, contrary to the respondent's assertion, which the Ninth Circuit found so persuasive, an account holder's investment in a federal mutual savings and loan association is not "risk-free." Obviously, the investment of any account holder in excess of the Federal Savings and Loan Insurance Corporation ("FSLIC") insurance coverage is totally at the risk of the business of the association. If the association fails, as did countless such institutions during the Depression and some modern day associations since then, none, or very little, of that investment may be recovered. *See, e.g.*,

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[6]In one much litigated case involving the merger of Long Beach Federal, a federal mutual savings and loan association, into a California guarantee stock-type association, the Board of Directors of Long Beach apparently did not act promptly enough to prevent such speculation, and the FHLBB took action on its own. In the merger, Long Beach account holders were to receive guarantee stock of the state association as payment for the value of Long Beach as a going concern. Prior to approval of the agreement by the FHLBB, there was an influx of large (over $100,000 each) investments in Long Beach accounts, which "had been opened . . . by 'celebrities of the financial and entertainment world widely known for their great wealth and business acumen.' " The FHLBB took the position that Long Beach management had breached its fiduciary duty to the existing shareholders by not rejecting these new applications for membership and required provisions in the merger agreement which in effect denied participation rights in the distributable guarantee stock to the extent that new accounts or additions to account balances after a fixed date exceeded $10,000. In addition, the provisions restricted "obvious 'insiders' " from participating in the distribution except to the extent of their accounts as of that date. *Federal Home Loan Bank Board v. Elliott*, 386 F.2d 42, 44-47 (9th Cir. 1967), *cert. denied*, 390 U.S. 1011 (1968).

Tcherepnin v. Knight, 389 U.S. 332 (1967) (account holders forced to bring a Rule 10b-5 suit under the Securities and Exchange Act to recover their investment).

Even the limited "insured" value of a share account holder's investment is at risk. That amount is not required to be paid in cash. The FSLIC has the option of meeting its matured obligations "by making available . . . a transferred account in a new insured institution in the same community or in another insured institution in an amount equal to the insured account. . . ." 12 U.S.C. § 1728(b) (1976). If the transferred account is a share account in a mutual association, it will be subject to the same withdrawal restrictions and risks of the business that were inherent in the original share account. Furthermore, the so-called insurance protection is only as sound as the corporation providing it. The FSLIC is the insurer of *all* federal savings and loan associations, and insures most state associations as well. In the event of an economic crisis threatening a significant number of insured associations, it would be impossible for it to cover all claims. Although the FSLIC's operations are supervised by the FHLBB, the FSLIC itself is not a governmental agency, and the United States is not liable for its obligations. The FSLIC has neither unlimited resources, nor is it guaranteed unlimited financial backing.

That Citizens Federal accounts represent a true equity interest in the association is further illustrated by an analysis of its obligation to make distributions on accounts. Although the respondent tries to portray these distributions as "interest," the facts do not support such a characterization. Unlike a depositor in a commercial bank, no Citizens Federal share account holder is legally entitled to a return from the association, either fixed or variable, on his investment. Rather, he receives dividends which are expressly dependent upon the financial success of the association. Charter K (Rev.) ¶ 10 (Jt. App. 43-44). Distributions on accounts are made only out of profits of the enterprise, ratably according to the size of the investment, and, under federal regulations, cannot be made at all if the association's capital reserve account falls below a given level. 12 C.F.R. § 563.14 (1976) (Pet. Br. App. 4).

The amount of the distribution on accounts, if any, is determined and declared periodically by the Board of Directors. Charter K (Rev.) ¶ 10 (Jt. App. 43-44). If the association is not profitable or its reserve and surplus are too low, no distribution will be made on any account, *and the association is liable for none*.[7] Charter K (Rev.) ¶ 10 (Jt. App. 43-44); *see also Federal Savings and Loan Insurance Corp. v. Huttner*, 401 F.2d 58, 61-62 (7th Cir. 1968) (holders of withdrawable shares in savings and loan association received dividends out of profits as declared by board of directors, not " 'interest' on money left on deposit"; consequently, FSLIC not liable for dividend expected by account holders but not credited before seizure of association due to impaired capital); *Lanigan v. Apollo Savings*, 353 N.E.2d 239, 242-43 (1976) (account holders in savings and loan association received dividends tied to profits and therefore have no right to post-default dividends despite availability of a liquidation surplus and belief that payments they had been receiving were "interest").

To our knowledge, no court has ever held that distributions made with respect to accounts in a savings and loan association are "interest." Instead, the courts have consistently held that such payments constitute dividends. *E.g., Federal Savings and Loan Insurance Corp. v. Huttner*, 401 F.2d at 61-62; *Fidelity Savings & Loan Association v. Burnet*, 65 F.2d 477, 479 (D.C. Cir.), *cert. denied*, 290 U.S. 652 (1933) (payments made to holders of passbook accounts are dividends paid on stock and do not constitute interest). The respondent himself took the same position for many years. Rev. Rul. 54-624, 1954-2 C.B. 16, 18. ("[D]istributions of earnings by Federal savings and loan associations constitute dividend income to the members of the as-

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[7]Although Citizens Federal is required by federal regulations to announce prior to issuance of certain types of "certificate" accounts the amount of dividends that it will distribute on those accounts *if net earnings are available to be paid out*, distributions on such accounts are also directly dependent upon the profitability of the association. Charter K (Rev.) ¶ 10 (Jt. App. 43). The association has no unconditional contractual obligation to make payments on any type of account. Similar terms are quite common for ordinary preferred stock.

sociations.''); I.T. 4045, 1951-1 C.B. 34.[8]

In I.T. 4045, the Commissioner stated:

> The distinction between the term ''dividend'' and the term ''interest'' is that interest ordinarily means a payment arising out of a debtor-creditor relationship with respect to the use of money at a fixed, predetermined rate, *whereas a dividend is a distribution of profits to shareholders* which is conditioned upon the existence of profits and a dividend declaration by a board of directors or similar body.
>
> . . .
>
> . . . [D]istributions of earnings by Federal savings and loan associations constitute dividend income to the members of the associations. . . .

Id. at 35. This definition is in accordance with the respondent's current regulations. Treas. Regs. § 1.316-1.[9]

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[8]Rev. Rul. 54-624 and I.T. 4045 have been declared obsolete, but have not been revoked or superseded. They are simply ''not considered determinative with respect to future transactions.'' Rev. Rul. 72-621, 1972-2 C.B. 651.

[9]The Ninth Circuit was ''persuaded'' that the payments of dividends by Citizens Federal did ''not qualify the . . . accounts as equity'' because of the deduction granted the association under section 591 of the Code. But as the Tax Court recently recognized in *Midwest Savings Association v. Commissioner*, 75 T.C. 262, 269 (1980), that section was enacted in 1951 specifically to grant a deduction to associations such as Citizens Federal *for dividends* paid to its shareholders which would *otherwise not have been deductible*, and was a clear recognition by Congress that the general Code provisions allowing a deduction for ''interest'' do not apply to such dividend distributions. *Id.* at 266. *See also Hudson City Savings Bank v. Commissioner*, 53 T.C. 70 (1969) (where respondent argued, and the Tax Court agreed, that section 591 of the Code is the exclusive statutory authority for the deductibility of distributions by corporations described therein). Certainly, neither this nor any other special tax benefit granted federal mutual savings and loan associations can alter the nature of the underlying relationship between the account holder and the association. Furthermore, the addition to the language of section 591 in 1962 of the words ''or interest'' was undoubtedly, as the court in *Midwest Savings* surmised, ''intended . . . as a liberalization to make clear the deductibility of distributions of profits *whether denominated* dividends or interest.'' *Id.* at 270 (emphasis added).

In sum, the account interests issued to the petitioners in the merger carry all the rights and indicia of stock: the right to vote and control the association, the right to receive dividends in amounts periodically determined and declared by the Board of Directors out of net profits, and the right to share proportionately in the residual assets of the association upon its liquidation, or to realize on the appreciation of those assets through disposition of the business. These same attributes have caused every court that has directly addressed the issue, until the Ninth Circuit below, to conclude that savings accounts representing shares in a *mutual* savings and loan association are stock.

The contention that share accounts such as those issued by Citizens Federal evidence a debtor-creditor relationship has been repeatedly rejected in a variety of contexts and is contrary to this Court's own classification of an account holder's interest in a mutual savings and loan association. In *Tcherepnin v. Knight*, 389 U.S. 332, 345 (1967), *rev'ing* 371 F.2d 374, 377 (7th Cir. 1967), this Court concluded that the equity characteristics and investment risks present in mutual savings and loan share accounts were sufficient to characterize them as ''stock'' within the meaning of the Securities and Exchange Act. This Court held:

> *Petitioners are participants in a common enterprise — a money-lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans. Because Illinois law ties the payment of dividends on withdrawable capital shares to an apportionment of profits, the petitioners can expect a return on their investment only if City Savings shows a profit. If City Savings fails to show a profit due to the lack of skill or honesty of its managers, the petitioners will receive no dividends.* Similarly, the amount of dividends the petitioners can expect is tied directly to the amount of profits City Savings makes from year to year. Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3(a)(10) and as it was defined in *Howey*. But we need not rest our decision on that conclusion alone. . . . *For example, the petitioners' shares can be viewed as ''certificate[s] of interest or participation in any profit-sharing agreement.'' The shares*

> *must be evidenced by a certificate, and Illinois law makes the payment of dividends contingent upon an apportionment of profits. These same factors make the shares "stock" under § 3(a)(10).*

389 U.S. at 338-39 (footnotes omitted and emphasis added).[10] *Accord, Fahey v. Mallonee*, 332 U.S. 245 (1947) (savings account holders of federal mutual association may bring stockholders' derivative suit).

The same characterization of the interest in issue was reached by the Court of Appeals for the District of Columbia Circuit in an opinion written by then Circuit Judge Burger. *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714 (D.C. Cir. 1961), *cert. denied*, 368 U.S. 938 (1961), *reh'g denied*, 368 U.S. 979 (1962). The court there rejected a challenge that new regulations issued by the FHLBB unlawfully permitted federal savings and loan associations to accept deposits, and thus act as banks. In his concurring opinion upholding the new regulations, Judge Burger, while noting that there are many "superficial similarities" between mutual savings and loan associations and banks, stressed certain material differences between accounts in a federal savings and loan association and deposits in a bank:

> [W]e are *concerned not with appearances but with legal realities*; it is here that the differences are marked as Judge Miller has pointed out. *The capital of a federal savings association is raised by payments on share interests. Calling them "payments" on "savings accounts" does not alter their legal status. That the payment may be regarded by the customer as a "deposit" or even called at times a deposit by the association does not make it a legal counterpart of a deposit in a bank. The "depositor" in a federal association is not a creditor* as is the depositor in a bank. . . . *He is an investor, as the very language of Section 5(b) of the Home Owners Loan Act describes the relationship*. The

[10]The respondent has publicly ruled that section 354 is applicable when a stock corporation is merged into a farmers' cooperative and that certificates of interest received by the former stockholders of the acquired corporation constituted "stock." Rev. Rul. 68-22, 1968-1 C.B. 142; *see also* G.C.M. No. 33673, at 2.

> owner of a "savings account" in the association is entitled to vote, in much the same way as a stockholder in a corporation, to elect the management. *The Act under which they exist recites the congressional purpose which emphasizes the "investment" character of these shares and distinguishes them from the creditor/debtor relationship between a bank account depositor and a bank.*

294 F.2d at 717-18 (citations omitted and emphasis added).

2. The Code Definitions of "Corporation," "Stock" and "Shareholder" and the Legislative History of Sections 368 and 354 Demonstrate a Congressional Intent That Associations Such as Citizens Federal Be Covered by the Reorganization Provisions of the Code.

The Ninth Circuit's decision in this case would hinder desirable reorganizations of savings and loan associations, a result that is contrary to Congressional intent. Congress expressed concern that different types of corporations should not be singled out for more restrictive application of the reorganization provisions of the 1954 Code when it (1) rejected portions of a House bill imposing more limiting rules for nontaxable reorganizations of "closely held" corporations, and (2) decided against the inclusion within those provisions of any precise definition of the term "stock." On the latter point, Senator Milliken of the Senate Committee on Finance stated in the Committee's Report:

> The House bill departs from existing law by introducing the new terms, "participating stock" (corresponding in general to common stock) and "nonparticipating stock" (corresponding in general to preferred stock). It not only defines these terms but also contains a definition of the term "security." Important tax consequences can flow from these definitions under the House bill. . . . *Your committee believes that any attempt to write into the statute precise definitions which will classify for tax purposes the many types of corporate stocks* and securities *will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments*. Accordingly, your committee has returned to the use of the terms "stock," "common stock," "securities," etc., and, as is the case under existing law, *has not attempted to define them in the statute*.

S. Rep. No. 1622, 83rd Cong., 2d Sess. 42 (1954) (emphasis added).

This language evidences a clear intent that the term "stock" for purposes of the reorganization provisions of the 1954 Code not be limited to instruments which are traditionally so denominated in common parlance. Moreover, by its refusal to define what would constitute "stock," Congress left for application to reorganizations the general statutory definitions contained in Section 7701 of the Code, which itself broadens, rather than limits, the term. Section 7701 includes within its express language the type of interests received by the petitioners. It states:

> . . . .
>
> (a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof —
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> . . . .
>
> (3) CORPORATION — The term "corporation" includes associations. . . .
>
> . . . .
>
> (7) STOCK — The term "stock" includes shares in an association. . . . [and]
>
> (8) SHAREHOLDER — The term "shareholder" includes a member in an association. . . .

I.R.C. § 7701(a). When these definitions are read together with sections 368 and 354 of the Code, which do "not otherwise distinctly express" what is meant when they use the above terms, the merger of Commerce and Citizens Federal comes precisely within the literal language of the Code.

Although, the reorganization provisions have been changed in some fashion or another in virtually every revenue act, Congress has never chosen to include in them a limiting definition of the key terms "stock," "shareholder" and "corporation." To the contrary, it repeatedly reenacted the above definitions, which clearly *expand* the meaning of the terms. Nor could this have gone unnoticed. In the Revenue Act of 1924, substantially the same guidance to the meaning of the word "stock" was contained in section 200(e), which provided that, "[w]hen used in this title . . . [t]he term 'stock' includes the share in an association. . . ."

Section 200(e) of the 1924 Act immediately preceded the sections dealing with corporate distributions and reorganization exchanges. Section 203(b) and (c) provided non-recognition of gain or loss upon the exchange of "stock or securities" in a corporate party to a reorganization.

Where Congress wished to qualify the breadth of the definitions of "stock" and "shareholder" contained in section 7701 (or its predecessors), or the application of the reorganization provisions to entities otherwise taxed as corporations, it did so in no uncertain terms. *See, e.g.*, § 247(b)(2) (defining "preferred stock" for purposes of the deduction for dividends paid on certain preferred stock) and former § 1361(m) (which expressly excluded certain partnerships and sole proprietorships electing to be taxed as corporations from the benefits of subchapter C of the Code, relating to corporate reorganizations); *see also* § 1083(f) (defining "stock or securities" for purposes of exchanges made in obedience to S.E.C. orders). The express qualifications of the term "stock," and of application of the reorganization provisions in other contexts, are yet further proof that Congress intended the term to be given its full meaning when used in sections 368 and 354 of the Code.

3. Without a Change in the Law, the Commissioner Abruptly Reversed His Position in the Mid-1960's on the Issue Presented, Even Though Prior to That Time He Had Consistently Treated Accounts in Mutual Savings and Loan Associations as Stock.

The respondent took the same position as the petitioners with respect to the nature of a mutual savings and loan association share account for many years. In Revenue Ruling 54-624, 1954-2 C.B. 16, 17-18, the respondent stated:

> A depositor in a bank has no voice in the management of the bank and he does not share in the distribution of the assets in the event of liquidation, dissolution or winding up of the business. However, each member of a Federal savings and loan association has, through participation in the election of a board of directors, a voice in the management of the association. In addition to the right to share in the profits, all holders of savings accounts are entitled to equal distribution of assets, pro rata to the value of their savings ac-

> counts, in the event of voluntary or involuntary dissolution or winding up of the association. *The rights possessed by the shareholders of [a federal mutual savings and loan] association are in the nature of proprietary interests which are not at all similar to the rights of a general or special depositor in a bank.*

(Emphasis added); *accord*, Rev. Rul. 58-34, 1958-1 C.B. 333, 334 (no debtor-creditor relationship exists between a federal savings and loan association and holders of savings accounts in such association); I.T. 4045, 1951-1 C.B. 34 (account holders are proprietors rather than creditors of the association).

Not surprisingly, the respondent also agreed with the petitioners that transactions such as the one at issue here constitute nontaxable reorganizations. *See* G.C.M. No. 33551 (May 31, 1967); *see also Estate of W. T. Hales v. Commissioner*, 40 B.T.A. 1245 (1939) (wherein respondent conceded that the acquisition of all the assets and liabilities of a state-chartered savings and loan association by a federal mutual savings and loan association in exchange for the latter's stock (share accounts) plus cash was a reorganization under section 112(g) of the Revenue Act of 1934).[11]

In 1969, the respondent officially reversed his position with respect to transactions such as the one in issue. In Revenue Ruling 69-6, 1969-1 C.B. 104, the respondent announced for the first time his view that a statutory merger of a stock-type savings and loan association into a mutual savings and loan association did not qualify as a reorganization. G.C.M. No. 33551 (May 31, 1967), prepared in connection with Revenue Ruling 69-6, states:

> Our view [in Revenue Ruling 69-6] of the nature of a membership interest in a mutual savings and loan association represents a modification of the position previously taken by this office. In G.C.M. 30596 (April 2, 1958) . . . we

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[11]Section 112(g) defined a reorganization to include "the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation. . . ."

> expressed the opinion that such a membership interest consists entirely of stock. We therefore concluded that the acquisitions involved constituted nontaxable reorganizations within the meaning of section 368(a)(1)(C). . . .

It is true that the Commissioner may change his interpretation of the law. *Dixon v. United States*, 381 U.S. 68 (1965); *Automobile Club of Michigan v. Commissioner*, 353 U.S. 180, *reh'g denied*, 353 U.S. 989 (1957). His interpretation, however, must have some basis in the law. There was no change in the statutes or the case law to warrant the respondent's "modification" of his position on the issue presented by this case, and there continues to be no support for the respondent's new position either in the Code or elsewhere. As a result, every court until the Ninth Circuit has justifiably spurned it.

4. All the Courts That Have Addressed the Issue, Except the Ninth Circuit in This Case, Have Concluded That Accounts in Mutual Savings and Loan Associations Are Stock Which Satisfies the Continuity of Proprietary Interest Test.

Over the past 15 years, the Court of Appeals for the Tenth Circuit, the Court of Appeals for the Sixth Circuit, the Court of Claims, the United States Tax Court and two district courts have all uniformly rejected the respondent's novel contention that share accounts in mutual savings and loan associations are equity interests for purposes of some reorganizations, but not for others. *See Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979); *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Owens v. Commissioner*, T.C. Memo. 1983-302 (May 26, 1983); *Paulsen v. Commissioner*, 78 T.C. 291 (1982); *Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980). Only the court of appeals below strayed from this solid line of precedent and succumbed to the respon-

dent's urging that it rewrite the law.[12]

In 1979, the Court of Claims in *Capital Savings & Loan Association* was presented with the question whether the statutory merger of Franklin, a state guaranty stock-type association into Capital, a mutual association whose capital consisted solely of voting share accounts, qualified as a reorganization under section 368(a)(1)(A) of the Code. *Id.* at 971-72. The Government in *Capital* contended that the receipt of Capital's share accounts pursuant to the merger violated the continuity of proprietary interest test, asserting that the accounts were a debt interest, which it characterized as the "equivalent of cash." 607 F.2d at 974. Consequently, it argued, the merger did not qualify as a reorganization. Under the Government's theory, the transaction constituted a sale because the Franklin shareholders had "in fact, 'cashed in' or sold their equity interest . . . when they accepted [the Capital share accounts] for [their guaranty] stock." *Id.*

Relying upon the same attributes present in the petitioners' Citizens Federal accounts and applying to the transaction the continuity of proprietary interest test as enunciated by this Court, the *Capital* court rejected the Government's theory and held that the merger was a reorganization. The Court of Claims reasoned:

> Though savings accounts are easily converted into cash, *as long as the account remains unliquidated, its holders continue their equity investment in the association in the form of share accounts*. Moreover, it must be observed that *the Government has admitted that Capital, a mutual association, is owned by its account holders, and this fact is inconsistent with its argument that these same accounts are debts if held by former holders of Franklin stock*. The nature of the Capital accounts, *i.e.*, the property interests in question, whether debt or equity, does not depend upon whether their holders were, prior to the acquisition by Capital of Franklin's assets, either holders of Franklin guaranty stock or holders of Capital savings accounts. Further, the debt or equity nature of savings accounts does not turn upon whether the accounts are exchanged in the merger of a mutual association into a mutual association or in the merger of a stock association into a mutual association. *Our inquiry must be into the nature of the proprietary interest in the affairs of Capital, if any, which rests in the holders of its accounts*.

Id. at 976 (emphasis added).

The *Capital* court likewise rejected the Government's argument "that there occurred an impermissible substantial change in the relationship of the Franklin shareholders because the value of the equity received [was] insignificant when compared to the value of the equity surrendered. . . ." *Id.* at 977. To this it responded, citing this Court's opinion in *Minnesota Tea Company*, 296 U.S. 378:

> Changes in the relationship of the former Franklin shareholder to the assets conveyed to Capital during the merger are permissible so long as the Franklin shareholder substantially continued his ownership interest in Capital. . . . This is *not* a case where an impermissible amount of *boot* and other securities was given *in addition to stock* as consideration for the exchange. In the transaction before the court, the *only consideration* which Capital could give or which the Franklin shareholders could receive, *Capital savings accounts, are proprietary interests* and in fact are the only proprietary interests in Capital.

Id. at 977 (citations omitted and emphasis added).

Finally, the *Capital* court expressly held that the redemption provision in the mutual association's charter (commonly denominated a "withdrawal" right) did not change its analysis and acknowledged, as the Government had warned in its brief, that its holding meant the former Franklin shareholders would not recognize any gain or loss on the transaction until they, partially or fully, disposed of their accounts:

> The focus must be on the nature of the interest itself; the duration of the interest does not control the determination

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[12] *Home Savings and Loan Association v. United States*, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975), which was relied upon by the court of appeals in this case, did not involve a mutual savings and loan association. The transaction at issue there was an acquisition by a guarantee stock-type association of two other guarantee stock associations. Prior to the mergers, all the stockholders of the acquired associations had sold out for cash.

> of whether an interest is debt or equity. . . . As long as the Capital account holders do not withdraw, they continue to hold their proprietary interests in the corporation. [T]hen and then only will their proprietary interest, to the extent of their withdrawal, be eliminated, or, as characterized by defendant, be "cashed in."

Id. at 977; *accord, Ward v. Commissioner*, 29 B.T.A. 1251 (1934), *petition on appeal dismissed*, 79 F.2d 381 (8th Cir. 1935) (right to require repurchase of stock received in a reorganization does not invalidate the reorganization); *see also International Telephone and Telegraph Corp. and Affiliated Cos. v. Commissioner*, 77 T.C. 60, 76-77, *supp. op.*, 77 T.C. 1367 (1981), *aff'd on another issue*, 704 F.2d 252 (2d Cir. 1983).

Thus, as the Court of Claims correctly recognized, the withdrawal provisions in mutual savings and loan association charters are merely a means by which the account holder may, if he wishes to do so at some time in the future, dispose of his share interest in the association; they do not alter the underlying equity nature of that interest. As this Court has itself pointed out, "[t]he critical time [at which continuity of proprietary interest must be determined] is the date of the exchange." It "makes no difference that, in the long run," the instrument may be sold or converted into some other form of consideration. *Helvering v. Southwest Consolidated Corporation*, 315 U.S. 194, 201 (1942), *reh'g denied*, 315 U.S. 829, *second pet. for reh'g denied*, 316 U.S. 710 (1942).

Both the *Capital* decision and the Tax Court's decision herein were solidly grounded in precedent. Eight years before *Capital*, the Court of Appeals for the Tenth Circuit held that such accounts constituted "voting stock" of an acquiring federal mutual savings and loan association within the meaning of section 368(a)(1)(C) and (2)(B) of the Code. *Everett v. United States*, 448 F.2d 357, 359-60 (10th Cir. 1971). In *Everett*, the respondent argued that a mutual savings and loan association's share account "interest more nearly represents that of a creditor than a true proprietary interest and hence cannot be said to constitute 'solely voting stock'." *Id.* at 359.

The *Everett* court flatly rejected that argument. It pointed out to the respondent that the statutory continuity of proprietary interest test applicable to asset acquisitions under section 368(a)(1)(C) (which is stricter than the judicially created test) requires only that "at least 80 percent of the fair market value of [the transferor's] assets be acquired *solely for* voting stock of [the transferee]." The adverb "solely," the court correctly noted, "*does not impose a qualitative restriction on the nature of the stock thus given by the acquiring corporation*. So, the question as to whether the [share accounts] constitute 'voting stock' . . . is not answered by the argument that such is not 'solely' voting stock." *Id.* at 359 (emphasis added).

Two years later, the Court of Appeals for the Sixth Circuit, applying the continuity of proprietary interest test to a transaction virtually identical to the one in issue here, agreed with the *Everett* court. It held that the merger of a state stock-type savings and loan association into a federal mutual savings and loan association, pursuant to which stock in the state association was converted into share accounts of the mutual association, satisfied the continuity of proprietary interest test and therefore qualified as a reorganization. *West Side Federal Savings and Loan Association v. United States*, 494 F.2d 404 (6th Cir. 1974).

In *West Side Federal*, the respondent recognized that West Side's share accounts represented the entire equity interest in the association and conceded that section 7701 brought the merger within the literal terms of the reorganization provisions of the Code. *Id.* at 409. There again, however, he asserted his "dual interest" theory, arguing that the equity interest of an account holder in a federal mutual savings and loan association "was minimal compared to his rights as a creditor" and that the conversion of the state association's stock into voting membership accounts in the federal mutual association pursuant to the merger was in essence an exchange of stock for "cash or its equivalent." *Id.* at 406, 409, 411. Once again, the respondent's contention was rejected. *Id.* at 411.

The Sixth Circuit began its analysis by carefully reviewing the continuity of proprietary interest requirement as first adopted by

this Court in *Pinellas Ice & Cold Storage Company*, and as later defined by the Court when confronted with various factual situations. It stated:

> These cases teach us [that] . . . [t]he sellers must acquire "a definite and substantial interest in the affairs of the purchasing corporation" and the interest which they acquire must represent a substantial part of the value of the thing transferred. Nevertheless, there is no requirement that the relationship of the transferor or its shareholders to the assets transferred remain substantially unchanged. The interest which the transferor or its shareholders acquire must be at least in substantial part a proprietary or equity interest and where only cash or debt obligations of the transferee are received there is no qualifying reorganization.

494 F.2d at 409.

With these principles as its guide, the Sixth Circuit examined the respondent's position with respect to mergers and consolidations and found it fraught with inconsistencies. *Id.* at 409-10. It appears that whether the respondent treats mutual savings and loan association share accounts as an equity interest or not depends upon the result he wants to reach.

Finally, the Sixth Circuit noted that Charter K (Revised) contradicts the respondent's assertion that holders of share accounts in an association governed by it are creditors and found it "improper" for the respondent to ignore the proprietary rights represented by such accounts. The court concluded:

> In each of the cases dealing with continuity of interest the focus has been on the *nature of the interest* in the acquiring corporation which is received in the exchange. *The courts do not conduct an examination to determine whether the shareholder of the merged corporation receives more or less of a proprietary interest than he surrendered. Instead, it is an analysis to determine if a proprietary interest is received.* . . .

Id. at 411 (emphasis added).

Two district court cases followed the Sixth Circuit's decision in *West Side Federal Rocky Mountain Federal Savings & Loan Association v. United States*, 473 F.Supp. 779 (D. Wyo. 1979); *First Federal Savings and Loan Association v. United States*, 452 F.Supp. 32 (N.D. Ohio 1978), *aff'd*, 615 F.2d 1360 (6th Cir. 1980). Both found that accounts in a federal mutual savings and loan association constituted "voting stock" for purposes of the reorganization provisions of the Code and upheld as nontaxable reorganizations acquisitions of state guaranty stock associations by federal mutual associations.

Each of the foregoing courts and the Tax Court recognized that whether "the relationship of the taxpayer to the assets conveyed was substantially changed" was not determinative of the issue at hand. *Minnesota Tea Co.*, 296 U.S. at 386. Instead, expressly following the principles enunciated by this Court, they focused on whether the transaction "partook of the nature of a reorganization, in that the seller acquired a definite and substantial interest in the purchaser." *Id.* That is, they asked what interest in the acquiring corporation the share accounts represented. Finding it to be an *ownership interest*, and therefore necessarily a continuing and "material stake in the affairs" of the modified corporate enterprise, those courts turned to the second part of the test: whether the instruments, the share accounts, representing that interest were received in exchange for "a substantial part of the value of the [stock or asset] transferred." 296 U.S. 385. In each case, as here, no other consideration was received and thus the transaction, otherwise within the plain language of the statutes, qualified for reorganization treatment under the Code.

The analysis of the Ninth Circuit in this case contrasts sharply with that of all the other courts. Although in its opinion the Ninth Circuit recites that the "interest received [by the shareholders of the acquired corporation in a reorganization] need not be the same form of equity interest given up," citing *Minnesota Tea Company*, it proceeds to ignore this Court's admonition and to construct a test of its own choosing.

As pointed out above, that new test, which the Ninth Circuit described as the "critical question" in determining whether a transaction qualifies as a reorganization, requires an inquiry into "whether the position of the shareholder in the reorganized entity has really changed: *has his risk increased or decreased*? *is his*

investment more or less liquid?'' 716 F.2d at 569 (Pet. App. 30) (emphasis added). Thus, if the interest received is readily saleable, that interest cannot qualify as ''stock'' for purposes of the reorganization provisions of the Code under the test applied by the Ninth Circuit, because the shareholder would have ''ready access'' to his money. *Id*. The Ninth Circuit accordingly concluded that since the risk and liquidity of the petitioners' position changed, no reorganization exchange occurred. Yet this Court has stated that such change is not ''inhibited by the statute.''

II.

THE POSITION TAKEN BY THE NINTH CIRCUIT INHIBITS BONA FIDE BUSINESS READJUSTMENTS IN AN INDUSTRY CONGRESS HAS ENCOURAGED, ARBITRARILY DISCRIMINATES AGAINST MUTUAL SAVINGS AND LOAN ASSOCIATIONS (MOST OF WHICH ARE FEDERAL) IN FAVOR OF STOCK-TYPE SAVINGS AND LOAN ASSOCIATIONS, AND CREATES UNCERTAINTY IN THE TAXATION OF REORGANIZATIONS INVOLVING OTHER TYPES OF CORPORATIONS.

In its opinion in *Capital Savings & Loan Association*, 607 F.2d at 976, the Court of Claims stated:

> [W]e join the courts in *West Side* . . . and *Everett* . . . in refusing to reach a decision which illogically implies that Capital is an association without owners *and which may unduly hinder otherwise desirable reorganizations*.

(Emphasis added).

There is no doubt that the *Capital* court's concern was well-founded. The ability to reorganize two businesses without incurring a tax is of vital importance in any industry, and is crucial to the savings and loan industry because of its unusual sensitivity to the vagaries of the economy. The FSLIC itself often uses forced mergers as a means of bolstering an association which is in an unsound financial condition.

Since at least as early as 1921, both Congress and the Treasury have recognized the utility of allowing all corporations to respond to the exigencies of the economy and to business conditions through readjustments and combinations of their operations and

ownership structures without the imposition of immediate taxation. Section 202(c) of the Revenue Act of 1921 specified certain property exchanges on which no gain or loss would be recognized unless the property received in the exchange had a ''readily realizable market value,'' but ''*in addition* [specified] certain classes of exchanges on which no gain or loss [would be] recognized *even if the property received in [the] exchange has a readily realizable market value*. . . .'' S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921) (emphasis added). The exchanges in the latter category specifically included ''cases . . . where in any corporate reorganization or readjustment stock or securities are exchanged for stock or securities of a corporation which is a party to or results from such a reorganization.'' S. Rep. No. 275, 67th Cong., 1st Sess. 11-12 (1921).

Essentially the same provision dealing with deferral of taxation on reorganization exchanges has been reenacted in every subsequent Revenue Act, and, until about 20 years ago, mutual savings and loan associations were routinely engaging in nontaxable reorganizations such as the one in issue here with the Treasury's blessing. *See* G.C.M. No. 33551 (May 31, 1967), prepared in connection with Revenue Ruling 69-6, 1969-1 C.B. 104; *Estate of W. T. Hales*, 40 B.T.A. 1245 (1939) (discussed *supra* at page 30). Congress was obviously aware of those transactions, yet has never excluded mutual savings and loan associations from the benefits of the reorganization provisions.

To the contrary, the protection and encouragement of mutual savings and loan associations, in particular, have been a long-standing concern of Congress. Section 5 of the Home Owners' Loan Act of 1933, 12 U.S.C. § 1464(a) (1976), stated:

> In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the [Federal Home Loan Bank] Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as ''Federal Savings and Loan Associations,'' and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home fi-

nancing institutions in the United States. Until 1980, *all* federally chartered savings and loan associations were required to be organized in mutual form.

Congress has also conferred special tax advantages on mutual savings and loan associations. For years, it exempted them from taxation on their profits, which provided a competitive advantage over commercial banks. *See Midwest Savings Association v. Commissioner*, 75 T.C. 262, 266 (1980), and authorities cited therein. The Revenue Act of 1951 removed that exemption because the associations were accumulating profits instead of distributing them to shareholders, thus avoiding taxation altogether. In operation, however, Congress continued to favor mutual savings and loan associations over other corporations by allowing them a deduction for the profits they distribute to their shareholders and by providing them with more generous limits on bad debt reserves. *Id*; I.R.C. §§ 591, 593. Given its historical treatment of these associations, it is illogical to assume that Congress ever intended that they be singled out for adverse discriminatory tax treatment in the manner urged by the respondent and now condoned by the Ninth Circuit.

The position taken by the respondent places an unwarranted burden on savings and loan associations organized in mutual form by putting them at a distinct competitive disadvantage compared with stock-type savings and loan associations. Under the respondent's unique position, a mutual association can acquire another mutual association in a reorganization, but cannot acquire a stock-type association in the same manner. On the other hand, a stock-type association can acquire another stock-type association or a mutual association in a reorganization. Because a mutual association could not trade equity for equity to acquire a stock-type savings and loan association without triggering adverse tax consequences to the stock-type association and its shareholders, the mutual association would have to pay a substantially higher price to achieve the same type of bona fide business combination available to other corporations on a tax-deferred basis.

More than half of the savings and loan associations in this country (and nearly all federal associations) are organized in

mutual form. U.S. League of Savings Institutions, *Source Book* 36-38 (1983). Because the respondent's position would discriminate against the acquisition of stock-type associations by mutual associations, many potential beneficial business combinations would be inhibited for no logical reason if the decision below is allowed to stand. That such combinations are a vital means of growth in the savings and loan industry is evidenced by their frequency in recent years. Officials of the FSLIC have advised counsel for the petitioners that some 425 mergers of savings and loan associations took place last year alone.

The respondent claims that "serious practical and administrative problems" would result if mergers such as the one at issue are accorded reorganization treatment because every account withdrawal would result in gain or loss (Resp. Br. on Pet. for Cert. at 7). Contrary to the respondent's contention, it is no more difficult to calculate gain on the disposition of part or all of a share account than it is to calculate gain on the sale of a share (or fractional share) of any stock. If failure to report exchange account withdrawals are the respondent's concern, it is a simple matter for the Internal Revenue Service to require that such accounts be segregated (as they already are in all the mergers of this type which counsel for the petitioners have seen), and that appropriate informational returns be filed by the associations each year to show withdrawals by the holders of those accounts.

Respondent's "parade of horribles" also raises the specter that account withdrawals might give rise to dividend income if accounts are equity, but that concern, as well, is more imagined than real. Section 301 of the Code, which governs corporate distributions in general, already applies to withdrawals of share interests from associations. *See Cornwall v. Commissioner*, 48 T.C. 736 (1967). Section 302(b)(1) of the Code excludes from dividend treatment redemptions that are not essentially equivalent to a dividend. Certainly non-pro rata, sporadic redemptions of shares at face value that occur in a savings and loan association which routinely pays out its earnings and profits to its shareholders would not be treated as dividends under that section.

Somehow the Internal Revenue Service dealt with these "serious practical and administrative problems" prior to 1963. In any event, the Court of Claims readily answered the respondent's administrative lament when it pointed out that

> ease of collection is not a criterion of taxability which courts should apply. Potential accounting and collecting difficulties do not warrant our disregarding the substance of a transaction, *an equity for equity exchange*, and denying reorganization treatment when appropriate.

607 F.2d at 977-78 (emphasis added).

Finally, because of the test applied to reach their result, the decision of the Ninth Circuit and the respondent's position affect *all* reorganizations, not simply those between savings and loan associations, and therefore seriously undermine the "need for certainty in the [reorganization] law. . . ." 78 T.C. at 303 (Pet. App. 16). As the Tax Court below fully recognized, that need is great because of the high stakes and advanced planning associated with reorganizations. "The practicality of many reorganizations is materially affected, if not determined, by the tax consequences, and the participants need to know the ground rules." 78 T.C. at 303 (Pet. App. 16).

If shareholders must be concerned whether they have, in exchanging equity for equity, received a "more or less liquid" security, or "increased or decreased" their investment risk, their ability to predict the consequences of reorganization exchanges will be significantly reduced. Will a merger of a financially troubled corporation whose shares are not traded in the open market into a nationally traded company whose stock can be sold in an instant by a mere telephone call qualify for reorganization treatment? Certainly the exchanging shareholder's risk and the liquidity of his investment will be radically altered in the transaction.

Such a far sweeping change resulting from the new "test" adopted by the Ninth Circuit should not be lightly undertaken. Judge Featherston, in his opinion for the Tax Court, brought this case into true focus when he concluded with the admonition of Justice Powell in *United States v. Byrum*, 408 U.S. 125, 135, *reh'g denied*, 409 U.S. 898 (1972):

> When a principle of taxation requires re-examination, Congress is better equipped than a court to define precisely the type of conduct which results in tax consequences. When courts readily undertake such tasks, taxpayers may not rely with assurance on what appear to be established rules lest they be subsequently overturned. Legislative enactments, on the other hand, although not always free from ambiguity, at least afford the taxpayers advance warning.

III.
CONCLUSION.

For the above reasons, the judgment of the court of appeals should be reversed.

Dated: May 9, 1984.

Respectfully submitted,

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APPENDIX.

[12 C.F.R.] § 546.4 [1976] Voluntary dissolution.

The board of directors of any Federal association may propose a plan for the dissolution of such association. Such plan may provide for (a) the Federal Savings and Loan Insurance Corporation to be appointed, in accordance with the provisions of section 406 of the National Housing Act, as amended, and section 5, Home Owners' Loan Act of 1933, as amended, and pertinent regulations of such corporation, as receiver for the purpose of liquidation; (b) all assets of the association to be transferred to another thrift and home-financing institution under Federal or State charter for a sufficient amount of cash to pay all obligations of the association and to retire all outstanding share accounts up to the amount credited thereto; (c) the transfer of all assets to another thrift and home-financing institution under Federal or State charter in consideration of the payment of all outstanding obligations of the association and the issuance of share accounts or other evidence of interest to the members of the Federal association on a pro rata basis; or (d) dissolution in such other manner as may be proposed by the directors and which to them appears to be to the best interest of all concerned. Such plan shall thereupon be submitted to the Board for approval, together with a statement of the reasons for proposing dissolution and the reasons for the plan submitted. If it appears to the Board that dissolution is advisable and that the plan of dissolution submitted is in the interest of all concerned, the Board will approve the plan; if the plan submitted appears to be inadvisable, the Board will either make recommendations to the association concerning the plan or disapprove it. When a play [sic] of dissolution has been approved [sic] the board of directors of a Federal association and by the Board, such plan shall be submitted to the members of such association at a duly called meeting and, when approved by a majority of the votes cast at such meeting, shall become effective. When dissolution has been consummated in accordance with the plan approved by the Board, a certificate evidencing that fact, supported by such evidence as the Board may require, shall forthwith be filed with the Board. Upon receipt of evidence sat-

isfactory to the Board that such dissolution has been so consummated, the Board will terminate the corporate existence of the dissolved Federal association and its charter shall thereby be cancelled.

[23 F.R. 9905, Dec. 23, 1958]

[12 C.F.R.] § 546.5 [1976] Conversion from Federal mutual to State charter mutual under last paragraph of subsection (i) of Section 5 of the Home Owners' Loan Act of 1933.

The following requirements are hereby prescribed for approvals pursuant to the last paragraph of subsection (i) of section 5 of the Home Owners' Loan Act of 1933, as amended:

(a) The conversion of an association shall be effected in accordance with a written plan approved by the Board, and in passing upon any such plan the Board may give consideration to any element of good-will value.

(b) The plan shall be submitted to the Board by action of the board of directors of such association prior to the giving of notice as hereinafter provided.

(c) The Board may prescribe such other substantive or procedural requirements as it deems necessary or proper to insure that the plan is fair and equitable to the association and its members.

(d) The association shall give formal notice of a special meeting called to vote on the plan, which shall be mailed, postage prepaid, at least 15 and not more than 45 days prior to the date of such meeting, and shall set forth the terms of the plan, the rights of the members, and such other matters as the Board may require. The use of said notice and accompanying proxy soliciting material, including the form of proxy, shall be authorized by the Board's Office of General Counsel before distribution is made to members.

(e) The plan shall be approved by a vote of at least a majority of the total votes eligible to be cast by members at the said special meeting.

(f) All requirements of or under State law shall have been complied with.

[40 FR 36310, Aug. 20, 1975]

[12 C.F.R.] §563.14 [1976] Payment of dividends and interest where losses are chargeable to the FIR.

No insured institution which has recognized losses chargeable to its Federal insurance reserve account may declare any dividends or pay any interest on savings accounts unless the amount standing to the credit of such account, after deduction of all such losses, is equal to at least the amount required under § 563.13. However, for any period when recognized losses are chargeable to such reserve and the amount remaining to the credit of such account after deduction of all such losses is less than the amount required under § 563.13, the declaration of such dividends or the payment of such interest on savings may be made if prior written approval is obtained from the Corporation. The Corporation hereby approves, for any such insured institution which has been insured for a period of 20 years or more and whose Federal insurance reserve account, prior to the charging of such losses, equalled at least 5 percent of all savings accounts, the declaration of dividends or the payment of interest on savings accounts, if such insured institution provides for the transfer to its Federal insurance reserve account of not less than 25 percent of its net income (as defined in § 572.3 of this subchapter) for such distribution period.

[37 F.R. 26581, Dec. 14, 1972]

No. 83-832

IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1983

Harold T. and Marie B. Paulsen,

Petitioners,
vs.

Commissioner of Internal Revenue,

Respondent.

AMICUS CURIAE BRIEF OF CALIFORNIA LEAGUE OF SAVINGS INSTITUTIONS IN SUPPORT OF PETITIONERS

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INTEREST OF AMICUS CURIAE

The California Savings and Loan League ("California League") is a trade Association organized as a tax exempt organization pursuant to Section 501(c)(6) of the Internal Revenue Code. Its membership consists of substantially all of the savings and loan associations, both stock and mutual, authorized to conduct business within the State of California. As of the final quarter of calendar 1983, there were approximately 250 such associations, of which about 150, with a total of approximately $165 billion in assets, were stock companies; and the remainder, with a total of approximately $25 billion in assets, were mutuals. Hence it has a profound interest in assuring that the laws pertaining to the

taxation of savings and loan associations are properly interpreted.

II

ARGUMENT

A. Under The Plain Language Of The Internal Revenue Code, As Heretofore Uniformly Interpreted By The Case Law, The Exchange, Pursuant to a Statutory Merger, By A Mutual Savings And Loan Association Of Its Stock In The Form Of Savings Accounts For The Guaranty Stock Of A Guaranty Stock Savings And Loan Association, Constitutes A Reorganization Within The Meaning Of Internal Revenue Code §368, And, Accordingly, Since The Savings Accounts Constitute Stock In A

Party To A Reorganization, The Exchange Is Tax Free At The Shareholder Level Under Internal Revenue Code §354.

Internal Revenue Code §354(a)(1) provides, in pertinent part, that "[n]o gain or loss shall be recognized if stock . . . in a corporation a party to a reorganization . . . [is], in pursuance of the plan of reorganization, exchanged solely for stock . . . in such corporation or in another corporation a party to the reorganization". Accordingly, the applicability of §354(a)(1) -- as well as the applicability of other Internal Revenue Code sections applicable to corporations themselves, including for example, 361, 362(b), and 381 -- depends upon whether the stock

held by the taxpayer is stock "in a corporation [which is] a party to a reorganization". If the stock is in a corporation which is a "party to a reorganization", §354 applies; if the stock is not in a corporation which is a party to a reorganization, §354 does not apply.

The identity of corporations which are parties to reorganizations is determined by Internal Revenue Code §368. It provides, in pertinent part, that "the term 'a party to a reorganization' includes . . . a corporation resulting from a reorganization"; and that "the term 'reorganization'" means, inter alia ". . . a statutory merger or consolidation . . ."

In order for a transaction to constitute a "statutory merger or consolidation" within the meaning of §368,

concededly there must be a "continuity of proprietary interest" as between the acquired corporation and the acquiring or consolidated corporation, in the sense that the proprietary interest of the owners of the acquired corporation is continued in the acquiring corporation.

The total universe of proprietary interests in a mutual savings and loan association -- the total bundle of rights constituting "ownership" -- historically has been represented by the savings accounts of such association. Accordingly, since savings accounts have been the sole form of proprietary interest available to a mutual association, courts to whom the issue has been presented have, prior to the decision of the United States Court of Appeals for the Ninth Circuit in Paulsen, uniformly

have held that when a mutual association acquires a stock association, the "continuity of interest" requirement of §368 is satisfied by providing the stockholders in the stock association with savings accounts in the mutual in exchange for their stock.

In West Side Federal Savings and Loan Association v. U.S., 494 F.2d 404 (6th Cir. 1974), for example, the United States Court of Appeals for the Sixth Circuit rejected the argument that the providing of savings accounts in an acquiring mutual association to the stockholders of the acquired stock association did not satisfy the continuity of propriety interest requirement because the savings accounts lacked the necessary incidents of ownership and therefore should be treated as cash equivalents, explaining:

". . . since a savings account is the only proprietary interest available in a federal mutual savings and loan association and the former shareholders of Parma received such accounts in exchange for their stock, it is improper to ignore the proprietary rights included in what they received and concentrate only on their rights as creditors. In each of the cases dealing with continuity of interest the focus has been on the nature of the interest in the acquiring corporation which is received in the exchange. The courts do not conduct an examination to determine whether the shareholder of the merged corporation receives

more or less of a proprietary interest than he surrendered. Instead, it is an analysis to determine if a proprietary interest is received, and the fact that what is received may be a mixture of proprietary interests and debt instruments of the acquiring corporation is not alone determinative." (494 F.2d 411).

Accord:

Capital Savings and Loan Association v. United States, 607 F.2d 970 (Ct. Cl. 1979); Everett v. United States, 448 F.2d 357, 359 (10th Cir. 1971).

See also:

Rocky Mountain Federal Savings and Loan Association v. United

States, 473 F.Supp. 779 (D.WY. 1979);

First Federal Savings and Loan Association v. United States, 452 F.Supp. 32 (N.D. OH 1978).

In the instant case, a mutual savings and loan association, Citizens Federal Savings and Loan Association ("Citizen"), acquired, pursuant to a statutory merger, a guaranty stock savings and loan association, Commerce Savings and Loan Association ("Commerce"), by exchanging its stock, in the form of savings accounts, for the guaranty stock of Commerce. Since the savings accounts constitute stock in a party to a reorganization, the exchange was tax free at the shareholder level under §354.

Why, then, did the United States Court of Appeals for the Ninth

Circuit conclude in Paulsen that §354 was inapplicable and that therefore the exchange of stock in Citizens for stock in commerce was not tax free at the stockholder level?

The Court reasoned, in essence, that because the issue was the applicability of a provision dealing with the tax consequences of a transaction to stockholders, §354, rather than the applicability of provisions dealing with the tax consequences to the corporation itself, satisfaction of the "continuity of interest" requirement depended not upon whether, from the corporate perspective, the stockholders in the acquired corporation continued to have an ownership interest in the enterprise but, rather, upon the characteristics of that ownership interest from the perspective of the stockholders; that the

"continuity of interest" test is not satisfied unless 1) the position of the stockholder before and after the merger is substantially unchanged in terms of the nature of his or her ownership interest and 2) the equity characteristics of the stock held in the merged corporation predominate over the debt characteristics thereof; that the fact that savings accounts "represent the entire capital structure" of a mutual association is "irrelevant . . . as far as §354 is concerned . . . [since] [t]he focus of that section is on the character of interests received from the point of view of the [shareholder] taxpayer, not that of the corporation"; that under Home Savings and Loan Association v. United States, 514 F.2d 1199 (9th Cir.), cert. den., 423 U.S. 1015 (1975), and

when viewed from the perspective of the shareholder taxpayer, the debt characteristics of savings accounts in a mutual association predominate over the equity characteristics; and that while "our decision conflicts with that reached by several other courts", including the decisions of the United States Court of Claims, in Capital Savings and Loan Association v. United States, supra, the United States Court of Appeals for the Sixth Circuit in West Side Federal Savings and Loan Association v. United States, supra, and the United States Court of Appeals for the Tenth Circuit in Everett v. United States, supra, "[w]e are neither bound nor persuaded by those authorities".

The merit -- or lack thereof -- in the reasoning of Paulsen has already been discussed, in extenso, in

the brief of Petitioners; and the League will not burden the Court by repeating their argument here. It does, however, have the following additional observations with respect to the Paulsen opinion.

First, and most basically, the fundamental premise of the opinion -- that the "continuity of interest" test is mutable and varies depending upon whether the issue is the application of a provision dealing with the tax consequences to the shareholder, such as §354, or the application of provisions dealing with the tax consequences at the corporate level, is false.

As the League has previously explained, §354 -- like reorganization provisions of the Internal Revenue Code such as §§361 and 362 applicable to corporations -- is derivative and

conditional. It applies when the stock held by the stockholder is in a "party to a reorganization"; the definition of "party to a reorganization" is contained in §368; and there is nothing in §368 or the case law interpreting it to suggest that satisfaction of the requirement that a corporation be a "party to a reorganization" depends upon whether the issue is the application of a provision dealing with tax consequences at the shareholder level or a provision dealing with the tax consequences at the corporate level. Indeed, any such determination would be an anomaly utterly devoid of any rational justification. Accordingly, the rationale invoked by Paulsen for using a "shareholder" perspective rather than a "corporate" perspective in applying the "continuity of interest" test simply is not valid.

Second, and as the League has also previously indicated, since the "continuity of interest" acquirement is a requirement at the corporate level the satisfaction of which must be determined based upon the perspective of the acquiring corporation, the characteristics of the stock held by the stockholders in the acquired corporation as compared to the characteristics of the stock received by the stockholders in the reorganized entity is immaterial. Hence all that is needed for "continuity of interest" is that the equity owners of the acquired guaranty stock association become equity owners in the reorganized entity, whatever the characteristics of that equity interest may be; and that requirement is clearly satisfied when the guaranty stockholders in the acquired association receive, in

exchange for their ownership interest, the only form of equity that the acquiring mutual association in Paulsen was empowered to issue -- its savings accounts.[1/]

[1/] The Respondent himself has recognized the significance of the proprietary interests of the account holders in a mutual savings and loan by requiring that those account holders be fully compensated for such propriety interests in any corporate level reorganization affecting the mutual. If a federal mutual savings and loan is merged into a stock association, the transaction will not qualify as a reorganization under §368 unless the account holders of the acquired mutual receive stock in the acquiring stock association equal in value to the total equity interests in the acquired mutual, in addition to equal value share accounts. (Rev. Rul. 69-646, 1969-2 C.B. 54.) Moreover, for the conversion of a mutual savings and loan into stock form to qualify as a reorganization under §368, the converting mutual must: (i) first offer subscription rights to all of its new stock to its account holders; and (ii) credit its account holders with a liquidation account in an amount equal to the net worth of the mutual at the time of the conversion. (Rev. Rul. 80-105, 1980-1 C.B. 78.) Finally, for the merger of a mutual savings and loan into another

Third, the Home Savings decision -- which constitutes the entire precedential tax law foundation for Paulsen -- is manifestly inapposite. Home, held that the continuity of interest requirement was not satisfied in connection with the "mergers" of two stock chartered savings and loans into stock chartered Home Savings. In those

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mutual to qualify as a reorganization under §368(a), the account holders of the acquired mutual must receive equity in the acquiring mutual, in the form of equal value share accounts. (Rev. Rul. 69-3, 1969-1 C.B. 103).

In 1980, federally chartered mutual associations were authorized to issue mutual capital certificates as an additional method of raising capital. (Public Law 96-221, 94 Stat. 132, 12 U.S.C. §1464; 12 C.F.R. §544.2(b)(4); 12 C.F.R. §563.7-4(1)(2).) The classification of such mutual certificates as debt or equity for tax purposes has never been judicially determined in any reported case or publically passed upon by the Respondent. In any event, because of the limited rights that the certificates confer under current regulations, they would appear to be generally unmarketable.

mergers, the stockholders of the acquired associations received solely cash in exchange for their stock, while the savings account holders of the acquired associations received savings accounts in Home Savings. The acquiring association, Home Savings, issued none of its permanent guaranty stock in connection with the mergers. Further, any equity characteristics of the savings accounts issued by Home Savings were totally subordinated to the "real" equity interest in the association, its permanent guarantee stock. In Paulsen, by contrast, the acquiring association, because it was mutually organized, represented the paramount, and indeed the only proprietary interest in such association. Yet despite these startling differences in the relevant facts, Paulsen concludes that the savings accounts issued by Home

Savings are the appropriate focus for determining the outcome of the issues presented in Paulsen.

Finally, if the Paulsen decision were to be upheld, mutual savings and loan associations -- as well as other mutually organized corporations -- would be subjected to a new and arbitrary body of rules at both the corporate and shareholder levels that have never been applied to non-mutually organized corporations. There is nothing in either the language of the Internal Revenue Code or its legislative history which even remotely suggests an intent on the part of Congress to discriminate against any class of corporations, or their stockholders merely because of the

form of organization of such corporations.[2/]

[2/] Arguably, however, the implications of Paulsen are far broader and more sinister than merely placing a limited category of corporations, mutual corporations, and the shareholders thereof in a disfavored status. Paulsen states that the "critical question" in determining whether or not the requirements for a reorganization have been satisfied is "whether the position of the shareholder in the reorganized entity has really changed . . ." Hence were Paulsen to be upheld, it would effectively overrule decisions, including decisions of this Court such as Minnesota Tea Co. v. Helvering, 296 U.S. 378 (1935) and John A. Nelson Company v. Helvering, 296 U.S. 374 (1935), holding that consolidations of non-mutual corporations could satisfy the requirements for a tax free reorganization notwithstanding the fact that the nature of what the exchanging shareholders held before and after the consolidation was qualitatively different.

B. The Practical Effect Of Adopting The Paulsen Rationale That The Exchange Of Savings Accounts In A Mutual Association For Guaranty Stock Association Does Not Satisfy The "Continuity Of Interest" Requirement For A Reorganization Within The Meaning Of IRC §368 Would Have Adverse Tax Consequences At The Shareholder Level, And Harsh, And Indeed Confiscatory, Tax Consequences At The Corporate Level.

As indicated in §III.A., supra, the practical effect of adopting the Paulsen rationale would be to preclude the direct acquisition of guaranty

stock savings and loan associations by mutual savings and loan associations from qualifying as tax freeing reorganizations within the meaning of §368. Instead the direct acquisition would be treated for tax purposes as though the stock association had sold its assets to the mutual association in a taxable transaction. LeTulle v. Scofield, 308 U.S. 415 (1940); Revenue Ruling 69-6, 1961 - 1 C.B. 104. The result would be adverse tax consequences at the shareholder level, with mutual savings and loan associations, unlike all non-mutual corporations, being unable to offer tax free consideration to shareholders in stock savings and loan association; and harsh, and indeed

confiscatory, tax consequences at the corporate level.[3/]

What are the tax consequences at the corporate level? They include the following:

1. Savings and loan associations, over more than three decades and pursuant to Internal Revenue Code §593 and its predecessors, have deducted from their taxable income and have accumulated enormous "bad debt" reserves not available to other corporate

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3/ There has been extensive merger activity in the savings and loan industry (see Petition for Writ of Certiorari in the within proceeding, p. 22); and the Paulsen decision could have critically important tax consequences for many of those consummated mergers.

taxpayers.[4/] In the case of a tax free reorganization within the meaning of Internal Revenue Code §368, such reserves are, pursuant to Internal Revenue Code §381(c)(4), carried over and treated as reserves of the acquiring association. Accordingly, no recapture

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[4/] Savings and loans were, in general, exempt from taxation until taxable years beginning after 1951. The Revenue Act of 1951 Act subjected savings and loan associations to the normal corporate income tax but allowed bad debt deductions up to 100 percent of taxable income. Accordingly, until the passage of the Revenue Act of 1962, savings and loan associations could commit their entire taxable income to their bad debt reserve balances. The Revenue Act of 1962 amended §593 to reduce the maximum bad debt reserve deductions to 60 percent of taxable income. Finally, the Revenue Act of 1969 provided for a gradual stepdown in the taxable income ceiling for bad debt deductions of savings and loans, currently scheduled to remain at 40 percent of taxable income. Overall, the maximum bad debt reserve of a savings and loan association which can be taken under the "percentage of taxable income" method is limited to 6% of its "qualifying real property loans". Internal Revenue Code §593(b)(1)(C).

taxes need be recognized by the acquired corporation. If, however, the direct acquisition were not a tax free reorganization within the meaning of §368, then, as described in Capital Savings and Loan Association, 607 F.2d 970 (Ct. Cl. 1979), the merging stock association could be required to report the entire balance of its bad debt reserves in its gross income for its final tax year. See West Seattle National Bank of Seattle v. Commissioner, 33 T.C. 341 (1959) aff'd., 288 F.2d 47 (9th Cir. 1961); Arcadia Savings & Loan Association v. Commissioner, 300 F.2d 247 (9th Cir. 1962). See also Internal Revenue Code §593(e). The tax liability could be extremely large.

2. The vast bulk of the assets held by savings and loan associations consists of long term real property mortgage loans; and because of

historical economic factors and the resulting low interest yields on such mortgage loans in relation to current market rates, in recent years most of them have, on the average, had a fair market value which is substantially less than their face values.[5/] If the direct

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[5/] In order to qualify as a savings and loan association for purposes of utilizing the special bad debt reserve allowances of § 593, a savings and loan must satisfy the definitional test requirements of Internal Revenue Code Section 7701(a)(19), as well as the asset investment test of Code Section 593(b)(2)(B). The net effect of such requirements is that a savings and loan which has taken full advantage of § 593 will have invested 82 percent or more of its assets in cash, government obligations and various types of real property mortgage loans. Savings and loans are also subject to regulatory proscriptions respecting permissible investments which, in practical effect limit a substantial percentage of their investment activity to residential real property lending. Home Owners' Loan Act of 1933, § 5 (12 U.S.C. § 1464(c)); California Financial Code §§ 7504, 7505. Nationwide deposits in FSLIC insured savings and loans totaled $793,858,000,000 in 1983; The real estate loan portfolios of such savings and loans approximate 70% of their total asset balances.

acquisition of a guaranty stock association by a mutual constitutes a reorganization under §368, the acquiring mutual association carries over the stock association's cost basis in the acquired mortgage loans and that cost basis is, for loans originated by the association, the amount advanced to the borrower less principal repayments to date. (See §362(b)). Accordingly, post acquisition repayments of principal by the borrower are treated as a return of capital and are not be taxable to the mutual association. If, however, the direct acquisition were characterized as a taxable purchase, the mutual's tax basis in the acquired mortgage loans would normally be limited to the

---

Nationwide investments by FSLIC insured savings and loans in real property loans in 1983 totaled $132,442,000,000 in that year. U.S. League of Savings Institutions, '83 Savings and Loan Sourcebook 8 (1983); 17 Federal Home Loan Bank Board Journal, 45, 50-52 (March, 1984).

mutual's cost basis, specifically the fair market value of those loans as of the date of acquisition thereof by the mutual association. (Code Section 1012). For tax purposes, these below market yield loans would be treated as discount obligations in the hands of the acquiring mutual association. Portions of the periodic repayments of principal by borrowers would be recharacterized as discount income and become subject to tax at ordinary interest rates. Hence the mutual would, as the result of the direct acquisition, assume a substantial deferred tax liability to be repaid over the life of the acquired loan portfolio. Burbank Liquidating Corporation v. Commissioner, 39 T.C. 999 (1963) modified 335 F.2d 125 (9th Cir. 1964), acq. 1965-1 C.B. 5; Darby Investment Corporation v. Commissioner, 37

T.C. 839 (1962), aff'd., 315 F.2d 551 (6th Cir. 1963); Revenue Ruling 73-558, 1973-2 C.B. 298.[6/]

[6/] To illustrate the aggregate effect of the tax consequences referred to in items 1 and 2 herein above, assume that the acquired stock association held $100 million in mortgages, with a current discounted fair market value of $85 million in mortgage loan; that the association has accumulated $3 million in bad debt reserve balances for federal income tax purposes, one-half the maximum allowable under the "percentage of taxable income" method of computing bad debt reserves set forth in §593(b)(2); and a net worth equal to 4% of assets, an amount approximately equivalent to the industry average. Federal Home Loan Bank, Statistical Division, Office of Policy and Economic Research, Washington, D.C. (Dec. 1983). If the direct acquisition does not qualify as a reorganization for purposes of Code Section 368(a)(1)(A), the stock association may be required to report $3 million dollars in taxable bad debt reserve recapture income in its final return, resulting in a tax liability of approximately $1,380,000, computed at maximum corporate tax rates. Further, the acquiring mutual would be required to report $15 million of ordinary discount income arising out of its ultimate collection of the $100 principal balance on the acquired mortgage loans, resulting in tax liabilities of approximately $4,140,000, computed at maximum corporate tax rates (after

3. Because of the adverse economic experience of the savings and loan industry over the past several years, many associations have had net operating and capital loss carryovers, unused investment credits, work incentive program credits and employee stock ownership credits. If the direct acquisition of a stock association by a mutual constitutes a reorganization under §368, such carryovers and credits of the merging stock association, would, pursuant to Internal Revenue Code §381(a)(2) and subject to the restrictions of Internal Revenue Code §§382(b)

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giving full effect to the bad debt deduction provided by §593(b)(2), but without considering the tax preference effect of Internal Revenue Code §57(a)(7).) The total additional corporate level tax liabilities tax liabilities resulting from this transaction could exceed the net worth of the association.

and 383, be carried over to the mutual. Otherwise they would be lost.[7/]

4. If direct acquisition of a stock association by a mutual is a reorganization under §368, the stock association would be entitled to the benefits of §361, providing for no recognition of gain or loss for tax purposes by the acquired association. Otherwise the direct acquisition would be treated as a Internal Revenue Code §337 sale of assets in the course of the complete liquidation of the stock association; and the merging stock association would be subject to depreciation recapture under §§1245 and 1250, recapture of the investment tax credits under §47(a), and to general legal principles applying the

---

7/ Stock associations seeking to acquire the business of other stock associations by means of a direct stock for assets merger would, however, be in the position to utilize the carryover provisions of §381(a)(2).

tax benefit doctrine, the assignment of income doctrine, and the "clear reflection of income" doctrine of §446(b) for the purpose of imposing additional taxes upon a liquidating corporation. (See, e.g., Bliss Dairy v. United States, 103 S.Ct. 1134 (1983), reversing 645 F.2d 19 (9th Cir. 1981); Idaho First Nat'l Bank v. United States, 265 F.2d 6 (9th Cir. 1959) (accrued but not yet due or payable interest taxed to liquidating cash basis bank).

III

CONCLUSION

The decision of the United States Court of Appeals for the Ninth Circuit in Paulsen is contrary both to settled law and sound public policy. It should be reversed.

Respectfully submitted,

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No. 83-832

In The

Supreme Court of the United States

October Term, 1983

HAROLD T. and MARIE B. PAULSEN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

JOINT APPENDIX

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PETITION FOR WRIT OF CERTIORARI FILED
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JOINT APPENDIX

RELEVANT DOCKET ENTRIES

United States Tax Court

HAROLD T. and MARIE B. PAULSEN,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 17549-79

Date	Filings and Proceedings
12/26/79	PETITION filed: fee paid
02/19/80	ANSWER by Resp. filed (c/s 2/13/80)
11/03/80	MOTION by Resp. for leave to file Amendment to Answer. (Amendment to Answer Lodged - c/s 10/30/80)
12/08/80-12/09/80	TRIAL at Seattle, WA before Judge Featherston

MOTION by Resp. filed Nov. 3, 1980 -
GRANTED Dec. 8, 1980

Stipulation of facts with exhibits attached filed 12/9/80

03/02/82 OPINION filed Judge Featherston

06/07/82 NOTICE OF APPEAL to U.S.C.A., 9th Cir., filed by Resp.

United States Court of Appeals
For The Ninth Circuit

HAROLD T. and MARIE B. PAULSEN,
Petitioners-Appellees,
vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Docket No. 82-7329

Date	Filings and Proceedings
06/10/82	DOCKETED CAUSE & ENTD APPEARANCE OF COUNSEL
04/05/83	Argued and Submitted before Hug, Poole, Norris, Cjj
08/16/83	ORDERED OPINION FILED (NORRIS) & JUDG TO BE FILED & ENTD.
08/16/83	FILED OPINION REVERSED
08/16/83	FILED & ENTD JUDGMENT
09/06/83	MANDATE ISSUED
09/19/83	Issued amended mandate to include costs
12/02/83	As of 12/1/83 Rec'd notice from SC re filing cert. # 83-832
02/27/84	Rec'd certified copy of Supreme Court's order granting cert.

UNITED STATES TAX COURT

HAROLD T. and MARIE B. PAULSEN,
Petitioners,
vs.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No. 17549-79

PETITION

The petitioners hereby petition for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his Notice of Deficiency (AP:SEA:90:RMF:MCB), dated September 26, 1979, and as the basis for their case allege as follows:

1. The petitioners, Husband and Wife, are individuals with legal residence now at 1035 South Whitman Street No. 1, Tacoma, Washington 98465. Petitioners' tax payer identification number is SSN539-05-5548. The return for the period herein involved was filed with the Office of Internal Revenue Service at Ogden, Utah.

2. The Notice of Deficiency (a copy of which is attached hereto and marked Exhibit "A") was mailed to the petitioners on September 26, 1979, and was issued by the Office of the Internal Revenue Service at Seattle, Washington.

3. The deficiencies as determined by the commissioner are in income taxes for the calendar year 1976, in the amount of $40,913, all of which is in dispute.

4. The determination of tax set forth in the said Notice of Deficiency is based upon the following errors:

(a) The commissioner erred in determining that the merger between Commerce Savings & Loan Association,

in which the petitioners were shareholders, and Citizens Federal Savings & Loan Association did not constitute a qualified organization within the meaning of § 368 (a) (1) (A) of the Internal Revenue Code of 1954.

(b) The commissioner erred in determining that the exchange of proprietary interest in stock in Commerce Savings & Loan for proprietary interest in Citizens Federal Savings & Loan, all pursuant to the merger agreement of November 7, 1975, constituted a taxable event.

(c) The commissioner erred in determining that Harold T. and Marie B. Paulsen are subject to a tax deficiency in the amount of $40,913 for the taxable year ending December 31, 1976.

5. The facts upon which the petitioner relies, as the basis of its case, are as follows:

(a) On or about July 1, 1976, the stockholders, of which the petitioners are two, of Commerce Savings & Loan Association, a State chartered savings and loan association, exchanged all of their common stock in the corporation for time certificates of deposit and restricted passbook accounts of Citizens Federal Savings & Loan Association of Seattle, Washington, a federally chartered mutual savings and loan association.

(b) Upon completion of exchange, Commerce Savings & Loan Association was merged into Citizens Federal Savings & Loan with the combined business activity being continued in the Citizens name.

(c) The exchange and merger were treated by the parties as resulting in the recognition of no gain or loss under § 354 (a) (exchanges of stock and securities in certain reorganizations) and § 368 (a) (1) (A), which defines "reorganizations" as including a statutory merger or consolidation.

(d) The face amount of time certificates and restricted passbook accounts received by shareholders for their 210,968 shares of commerce stock totalled $2,531,-616.00. The stock had a par or stated value of $2.50.

(e) The shareholders had the election of receiving either time certificates of one- to ten-year maturity, or restricted passbook accounts, from which no withdrawal could be made for a period of one year.

(f) With regard to Commerce's bad debt reserves, no bad debt charge-off was required by specific orders of the supervisory authorities having jurisdiction over the taxpayer's operations for this period ending June 30, 1976.

(g) With regard to the voting privileges associated with Citizens Federal Savings and Loan passbook accounts and time certificates:

> Citizens Federal, the transferee of all of the taxpayer's assets and liabilities, is a federally chartered, mutual association. Votes of the membership in the election of directors and other matters are cast by the depositors and borrowers on the following basis:
>
> > Depositors—One vote for each $100.00 of deposit or fraction thereof of withdrawable value to a maximum of 50 votes per depositor (subsequently amended to 400 votes per depositor).
> >
> > Time Certificate Holders—Same as for depositors.
> >
> > Mortgagors—One vote regardless of loan amount.

(h) Under the terms of its Federal charter, Citizens Federal Savings and Loan Association is a mutual savings and loan association owned entirely by its members who are savings account holders and borrowers. Such

members are entitled to vote on all matters requiring such action, and are entitled to vote on all matters requiring such action (sic), and are entitled to share in any distribution of assets, pro rata to the value of the accounts, in the event of voluntary or involuntary liquidation, dissolution, or winding up of the association. No other type of equity security or proprietary interests may exist in the association.

(i) The Internal Revenue Code recognizes the similarities between membership in such an association and a stock or proprietary interest in a corporation in its definitions included in I.R.C. Section 7701(a):

> "Stock—The term stock includes shares in an association, joint-stock company, or insurance company."
>
> "Shareholder—The term shareholder includes a member in an association, joint-stock company, or insurance company."

(j) The charter of the association emphasizes the distinction between savings account holders (members) and creditors in imposing certain restrictions on withdrawals. "Holders of savings accounts for which applications for withdrawal have been made shall remain holders of savings accounts until paid and *shall not become creditors.*" (Last sentence of paragraph 6 in the Charter.)

(k) Petitioners have exchanged their proprietary interest in the stock of Commerce Savings and Loan Association for a similar proprietary interest in the successor association Citizens Federal Savings and Loan Association and have not realized a gain on the disposition of stock.

As of July 31, 1978, over two years after the merger, 73.9 percent of the savings accounts and certificates of

Citizens Federal Savings & Loan Association issued for shares of Commerce Savings & Loan Association stock, were held by the same persons or the same interests (in the case of heirs of certificate holders).

WHEREFORE, the petitioners pray that the court may hear the proceeding and:

1. Determine that the commissioner erred as alleged in each assignment of error set forth in paragraph 4 hereinabove;

2. Find that there is no deficiency in income tax for the taxable year ending December 31, 1976.

3. Give such other and further relief as the court may deem fit and proper.

/s/ Duane Tewell of Elvidge, Veblen, Tewell, Bergmann & Thorpe

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DATED this 19th day of December, 1979.

(Statutory Notice of Deficiency, Exhibit "A" to Tax Court Petition, omitted in printing.)

UNITED STATES TAX COURT

(Title omitted in printing)

ANSWER

THE RESPONDENT, in answer to the petition filed in the above-entitled case, admits, denies and alleges as follows:

1. Admits the allegations of paragraph 1 of the petition.

2. Admits the allegations of paragraph 2 of the petition except it is denied that a copy of the notice of deficiency is attached to the copy of the petition served upon the respondent. Alleges that a complete copy of the statutory notice of deficiency is attached as Exhibit A.

3. Admits the allegations of paragraph 3 of the petition.

4(a) to (c), inclusive. Denies the allegations of subparagraphs (a) to (c), inclusive, of paragraph 4 of the petition.

5(a) to (d), inclusive. Admits the allegations of subparagraphs (a) to (d), inclusive, of paragraph 5 of the petition.

(e) Admits that the shareholders had the right to receive restricted passbook accounts, from which no withdrawal could be made for a period of one year. The respondent currently lacks knowledge or information sufficient to form a belief as to the truthfulness of the remaining allegations contained in subparagraph (e) of paragraph 5 of the petition, and therefore denies same.

(f) Admits the allegations of subparagraph (f) of paragraph 5 of the petition.

(g) The respondent lacks knowledge or information as to whether the charter of Citizens Federal Savings and Loan Association of Seattle was subsequently amended to permit 400 votes per depositor and therefore denies same. Admits the remaining allegations of subparagraph (g) of paragraph 5 of the petition.

(h) Admits that under the terms of its Federal charter, Citizens Federal Savings and Loan Association is a mutual savings and loan association owned entirely by its members who are savings account holders and borrowers. The respondent currently lacks knowledge or information sufficient to form a belief as to the truthfulness of the remaining allegations contained in subparagraph (h) of paragraph 5 of the petition, and therefore denies same.

5(i) Admits that I.R.C. §7701(a) provides, in part:

"Stock—The term stock includes shares in an association, joint-stock company, or insurance company."

"Shareholder—The term shareholder includes a member in an association, joint-stock company, or insurance company."

Denies the remaining allegations of subparagraph (i) of paragraph 5 of the petition.

(j) The respondent currently lacks knowledge or information sufficient to form a belief as to the truthfulness of the allegations contained in subparagraph (j) of paragraph 5 of the petition, and therefore denies same.

(k) Denies that petitioners have exchanged their proprietary interest in the stock of Commerce Savings

and Loan Association for a similar proprietary interest in the successor association Citizens Federal Savings and Loan Association and have not realized a gain on the disposition of stock.

The respondent currently lacks knowledge or information sufficient to form a belief as to the truthfulness of the remaining allegations contained in subparagraph (k) of paragraph 5 of the petition, and therefore denies same.

6. Denies generally each and every allegation of the petition not hereinbefore specifically admitted, qualified or denied.

WHEREFORE, it is prayed that the deficiency determined by the respondent be in all respects approved.

N. Jerold Cohen
Chief Counsel
Internal Revenue Service

By: /s/ Richard J. Shipley
District Counsel

Dated: Feb. 13, 1980

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(Certificate of service omitted in printing.)

(Statutory Notice of Deficiency, Exhibit "A" to Tax Court Answer, omitted in printing.)

UNITED STATES TAX COURT

(Title omitted in printing)

AMENDMENT TO ANSWER

THE RESPONDENT, for Amendment to the Answer filed in the above-entitled case, adds after paragraph 6 and prior to the prayer the following allegations:

7. IN FURTHER SUPPORT of the determination that the exchange by petitioners of 17,459 shares of common stock of Commerce Savings & Loan Association for certain time certificates and passbook savings accounts of Citizens Federal Savings and Loan Association in the total amount of $209,508.00 did not qualify as a tax-free exchange, and in support of respondent's claim for an increased deficiency in income for the taxable year 1976, the respondent alleges:

(a) In the explanation of items included as part of the statutory notice of deficiency issued to the petitioners, it is stated that the petitioners realized gain on the exchange of 17,459 shares of common stock of Commerce Savings & Loan Association for certain time certificates and passbook savings accounts of Citizens Federal Savings and Loan Association, a nonstock, federally-chartered savings and loan association, in the amount of $152,706.00.

(b) The explanation of items further indicates that the gain realized on 16,069 shares of such stock is subject to capital gain treatment and the remaining 1,390 shares are subject to ordinary income treatment.

(c) The statutory notice was based on the theory that the passbook savings accounts and time certificates were received by the petitioners in exchange for their stock in Commerce Savings and Loan Association.

(d) In the alternative, it is respondent's position that petitioners' exchange of Commerce Savings and Loan Association stock for passbook savings accounts and time certificates in Citizens Federal Savings and Loan Association, results in recognition of the entire amount of the gain realized pursuant to I.R.C. §§ 354 and 356(a)(2).

(e) Pursuant to this alternative argument, the passbook savings accounts and time certificates constitute pro rata "boot" distributed in connection with a reorganization and are dividend income to the extent of gain recognized on the exchange by the petitioners and to the extent that Commerce Savings and Loan Association had sufficient earnings and profits.

(f) The petitioners had, under this alternative theory, additional gain in the amount of $152,706.00, of which $74,831.00 is dividend income, with the remainder of $77,875.00 treated as capital gain ($76,137.00) or ordinary income ($1,738.00) because of an early disposition of option stock.

(g) The petitioners, accordingly, had additional tax due of $52,107.00 for the taxable year 1976.

WHEREFORE, the respondent prays that the Court redetermines (sic) the deficiency in income tax for the taxable year 1976 to be the amount determined by the respondent, in the statutory notice of deficiency, namely, $40,-

913.00, or in the alternative $52,107.00 as alleged in this Amendment to Answer.

N. Jerold Cohen
Chief Counsel
Internal Revenue Service

By: /s/ Richard J. Shipley
District Counsel

Dated: Oct. 30, 1980

Of Counsel:

Emory L. Langdon
Regional Counsel
Wayne R. Appleman
Attorney
Internal Revenue Service
Rm: 2710 Federal Building
915 2nd Ave.
Seattle, Washington 98174
Tel: (206) 442-5267

(Certificate of Service omitted in printing.)

UNITED STATES TAX COURT

(Title omitted in printing)

STIPULATION OF FACTS

The parties hereby stipulate and agree that for the purpose of this case, the following facts and exhibits attached hereto and made a part hereof may be taken as true.

1. The petitioners currently reside in Tacoma, Washington. The mailing address and legal residence of the petitioners at the time of the filing of their petition with this Court was 1035 South Whitman Street #1, Tacoma, Washington 98465.

2. Petitioners filed their income tax return for the calendar year 1976 with the Western Service Center, Ogden, Utah. Attached hereto and made a part hereof is Joint Exhibit 1-A as a true and correct copy of said return.

3. The Commissioner of Internal Revenue raised a Statutory Notice of Deficiency to the petitioners on September 26, 1979, alleging a deficiency in income tax for the calendar year 1976 in the amount of $40,913. Attached hereto and made a part hereof as Joint Exhibit 2-B is a true and correct copy of said Statutory Notice of Deficiency.

4. Commerce Savings and Loan Association of Tacoma, Tacoma, Washington (hereinafter sometimes referred to as Commerce) was a State-chartered savings and

loan association incorporated and operating under the laws of the State of Washington. Attached hereto and made a part hereof as Joint Exhibits 3-C and 4-D are true and correct copies of the articles of incorporation, and bylaws of the Commerce Savings and Loan Association, respectively.

5. Citizens Federal Savings and Loan Association of Seattle, Washington (hereinafter sometimes referred to as Citizens Federal), is a federally-chartered mutual savings and loan association, authorized, organized, and chartered by the Federal Home Loan Bank Board under the provisions of 12 USC, §1461 *et seq* and the regulations promulgated thereunder. Attached hereto and made a part hereof as Joint Exhibit 5-E is a true and correct copy of the official charter and bylaws of Citizens Federal Savings and Loan Association.

6. Petitioner Harold T. Paulsen was president and a director of Commerce during the twelve-month period preceding June 30, 1976. At all time (sic) material hereto, petitioner Harold T. Paulsen and petitioner Marie B. Paulsen were and are husband and wife. All of petitioners' stock in Commerce Savings and Loan was owned as community property by Harold T. and Marie B. Paulsen.

7. On June 30, 1976, the petitioners owned 17,459 shares of stock in Commerce. Petitioners acquired 1,390 shares of stock on June 30, 1976, pursuant to a qualified stock option plan.

8. On or about July 1, 1976, the stockholders of Commerce exchanged all of their stock in Commerce for passbook accounts and time certificates of deposit of Citizens

Federal. The exchange was in accordance with the provisions and/or the intent of the Plan for Merger. Attached hereto and made a part hereof as Joint Exhibit 6-F is a true and correct copy of the Plan for Merger.

9. Upon completion of the exchange of stock for passbook accounts and time certificates of deposit, Commerce was merged into Citizens Federal with the combined business activity being continued in Citizens Federal's name.

10. The exchange and merger were treated by Citizens Federal and Commerce as a reorganization pursuant to Section 368(a)(1)(A), resulting in no recognized gain or loss to Commerce shareholders pursuant to Section 354(a). Petitioners treated the exchange and merger as requiring the recognition of gain realized on the time certificates as of the date of their maturity and gain realized on the passbook accounts as of the date of withdrawals. Petitioners have made no withdrawals from their passbook accounts between July 1, 1976 and the present.

11. At the time of the merger, the shareholders of Commerce tendered to Citizens Federal 210,968 shares of Commerce stock. This represented all the outstanding stock of Commerce.

12. At the time of the merger, Citizens Federal tendered $2,531,616 to the shareholders of Commerce, in the form of passbook accounts and time certificates of deposit in exchange for the Commerce stock. The shareholders of Commerce received the following passbook accounts and time certificates.

	NO. OF ACCOUNTS	AMOUNT	PERCENT OF TOTAL
Passbooks—restricted	73	$ 671,040	26.5
Certificates:			
12 months	68	823,740	32.5
18 months	15	288,132	11.4
20 months	1	91,728	3.6
24 months	4	88,788	3.5
29 months	1	12,000	.5
30 months	10	129,756	5.1
36 months	6	84,156	3.3
48 months	19	251,532	9.9
54 months	2	7,848	.3
60 months	2	10,296	.4
72 months	6	33,072	1.3
80 months	1	3,864	.2
84 months	1	2,400	.1
96 months	1	1,800	.1
108 months	1	1,404	.1
120 months	1	24,060	1.0
		$2,531,616	100.0

13. Pursuant to the provisions of paragraph 11(c) of the Plan For Merger (Joint Exhibit 5-E), the shareholders of Commerce exchanged each share of capital stock in Commerce for a $12 deposit in a regular passbook savings account in Citizens Federal, with said deposit not to be withdrawn for a period of one year. The shareholders also had the option of exchanging their shares at the same rate for time certificates of deposit of one- to ten-year maturity in Citizens Federal. Although this option was the intent of the parties, through a typographical error, the Plan for Merger does not reflect the second option.

14. Citizens Federal is owned by its members consisting of all savings account holders and borrowers. Mem-

bers possess all the proprietory interests existing in Citizens Federal. Citizens Federal has no capital stock.

15. Paragraph 11(c) of the Plan for Merger (Joint Exhibit 5-E) also provided that each prior shareholder of Commerce shall have borrowing privileges against the resulting deposits at a rate of 1.5 percent above the passbook rate. The passbook rate during the period July 1, 1976, through June 30, 1977, was 5.25 percent.

16. Citizens Federal savings account holders, other than former shareholders of Commerce, were charged a rate of 2.0 percent above the passbook rate on loans secured by their accounts.

17. On July 1, 1976, the petitioners exchanged the following shares of capital stock in Commerce for passbook and time certificates of deposit in Citizens Federal:

Date of Acquisition	# Shares	Cost Basis	Consideration Received	Type	Gain
3- 8-63	3,356	$ 7,500	$ 40,272	Passbook	$ 32,772
6-26-70	3,359	7,500	40,308	2 yr. cert.	32,808
12-31-71	3,358	7,500	40,296	18 mos. cert.	32,796
10-24-72	3,358	7,500	40,296	18 mos. cert.	32,796
1- 1-73	667	7,530	8,004	1 yr. cert.	474
2-19-74	1,971	6,000	23,652	3 yr. cert.	17,652
6-30-76	861	7,500	10,332	3 yr. cert.	2,832
6-30-76	529	5,772	6,348	4 yr. cert.	576
	17,459	$56,802	$209,508		$152,706

18. The undistributed earnings and profits of Commerce, accumulated after February 28, 1913, were $1,164,-029.00 on June 30, 1976.

N. Jerold Cohen
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Internal Revenue Service

By: Richard J. Shipley
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EXHIBIT 3-C

ARTICLES OF INCORPORATION
of
COMMERCE SAVINGS AND LOAN ASSOCIATION

KNOW ALL MEN BY THESE PRESENTS:

That the undersigned, LESTER S. BASKIN, E. H. BRUS, R. GENE GRANT, J. S. MARTINAC, CARL L. PHILLIPS, A. R. WALKER, J. A. WOODWORTH and PAUL R. KIRK, each being above the age of twenty-one years, citizens of the United States and residents of Pierce County, Washington, do hereby associate themselves together for the purpose of forming a savings and loan association, under the laws of the State of Washington, and in pursuance thereof do hereby sign and acknowledge the following Articles of Incorporation in quadruplicate originals, and do state as follows:

ARTICLE I

That the name of the corporation shall be COMMERCE SAVINGS AND LOAN ASSOCIATION.

ARTICLE II

That the principal place of business of the corporation shall be in the City of Tacoma, County of Pierce, State of Washington.

ARTICLE III

That the purpose of this corporation is to conduct a savings and loan association under the laws of the State of Washington, and to transact such business and to perform such acts as are permitted under the laws of the State of Washington for such association and corporation.

ARTICLE IV

The duration of this corporation shall be perpetual.

ARTICLE V

The amount of paid-in savings with which the corporation will commence business shall be and is the sum of $200,000.00.

ARTICLE VI

The shares of guaranty stock issued by the Association shall be of a par value of $100.00 per share and the minimum amount of such stock shall be $75,000.00 when issued and shall be fully paid and maintained as fixed and permanent non-withdrawable capital. Guaranty stock may be issued in the amount set forth in these Articles of Incorporation and shall be maintained in the greater of the following amounts.

(a) The amount of guaranty stock required by Chapter 33.48, Section .030 of the Revised Code of Washington relating to Guaranty Stock State Savings and Loan Associations.

(b) An amount equal to two per cent (2%) or the first $10,000,000.00 of withdrawable shares, plus one per cent (1%) of all withdrawable shares in excess of $10,000,000.00, provided, however, that with respect to the requirements of this sub-section (b) only, undivided profits may be earmarked as a substitute for stock up to fifty per cent (50%) of the stock requirements, but not in excess of $50,000.00, for a period of time not to exceed three years, and all undivided profits so earmarked shall be subject to all the limitations which apply to stock; and provided

further that whenever the aggregate amount of guaranty stock is less than the requirements herein specified, cash dividends, computed on the latest fiscal year-end book value of the guaranty stock, shall not be higher than the lowest rate paid on withdrawable share accounts.

ARTICLE VII

That for a period of five years from the date of approval of these Articles of Incorporation by the Supervisor of the Division of Savings & Loan Associations of the State of Washington, no share of guaranty stock shall be voted affirmatively without the prior written approval of the said Supervisor for any proposal which would have the effect of sale, conversion, merger or consolidation with any foreign savings and loan association or affiliated financial interest; this Article shall not be revoked, altered or amended without the prior written approval of the said Supervisor; and that the provision of this Article shall be endorsed upon all certificates of guaranty stock issued by the said Association.

ARTICLE VIII

The first directors of this corporation and their respective occupations and post office addresses are as follows:

Name	Occupation	Address
Lester Baskin, M.D.	Physician and Surgeon	906 N. Tacoma Ave. Tacoma, Wash.
E. H. Brus	Investments	11414 Clovercrest Dr., S.W., Tacoma, Wash.
R. Gene Grant	Vice President, Cheney Lumber Co.	10422 Brook Lane S. W. Tacoma, Wash.
J. S. Martinac	President, Martinac Shipbuilding Company	11518 Gravelly Lake, N.W. Tacoma, Wash.
Carl L. Phillips	Retired	13 Forrest Glen Lane S.W. Tacoma, Wash.
A. R. Walker	Retired	23 Lagoon Lane Tacoma, Wash.
J. A. Woodworth	President, Woodworth & Co., Inc., General Contractors	424 North "D" St. Tacoma, Wash.
Paul R. Kirk	President, G. R. Kirk Co., Christmas Trees	7119 Interlaken Drive S.W. Tacoma, Washington

ARTICLE IX

The name, occupation and place of residence of each incorporator is as follows:

Name	Occupation	Address
Lester Baskin, M.D.	Physician and Surgeon	906 N. Tacoma Ave. Tacoma, Wash.
E. H. Brus	Investments	11414 Clovercrest Dr., S.W., Tacoma, Wash.
R. Gene Grant	Vice President Cheney Lumber Co.	10422 Brook Lane S. W. Tacoma, Wash.
J. S. Martinac	President, Martinac Shipbuilding Company	11518 Gravelly Lake N. W. Tacoma, Washington
Carl L. Phillips	Retired	13 Forrest Glen Lane S. W. Tacoma, Washington
A. R. Walker	Retired	23 Lagoon Lane N. Tacoma, Washington
J. A. Woodworth	President, Woodworth & Co., Inc., General Contractors	424 North "D" Street Tacoma, Washington
Paul R. Kirk	President, G. R. Kirk Co., Christmas Trees	7119 Interlaken S. W. Tacoma, Wash.

IN WITNESS WHEREOF, the incorporators have hereunto set their hands and seals this 6th day of July, 1962.

(Subscriptions omitted in printing.)

(Jurat omitted in printing.)

(Approval of compliance omitted in printing.)

(Receipts for fees and Articles of Incorporation omitted in printing.)

(Certification of Articles of Incorporation omitted in printing.)

EXHIBIT 4-D

BY-LAWS OF
COMMERCE SAVINGS AND LOAN
ASSOCIATION OF TACOMA
TACOMA, WASHINGTON

ARTICLE I

MEMBERSHIP

Section 1: Each holder of a savings account or guaranty stock in this association shall be a member and shall have, except as limited by further provisions of these by-laws, a proportionate proprietory interest in its assets or net earnings subordinate to the claims of its creditors, except that in case of involuntary liquidation, juvenile and school savings accounts will be entitled to be paid in full before the distribution of remaining assets to other accounts and as further excepted in Article II of these by-laws. Each borrower and each contract purchaser indebted to the association shall also be a member. Savings accounts may be held absolutely by, or in trust for, any person, including an individual, male or female, adult or minor, single or married, a partnership, association or corporation. Two or more persons may hold savings accounts jointly with right of survivorship or in any other manner permitted by law. The State of Washington and the municipal corporations thereof, and trustees, administrators, executors, guardians and other fiduciaries, either individuals or corporate, in their fiduciary capacity, may become members.

ARTICLE II

GUARANTY STOCK

Section 1: The shares of guaranty stock issued by the association shall be of a par value of $100.00 [Illegible handwritten amendments to par value omitted] per share and the minimum amount of such shall be $240,000 when issued and shall be fully paid and maintained as fixed and permanent nonwithdrawable capital. Guaranty stock may be issued in the amounts set forth in the Articles of Incorporation and shall be maintained in the greater of the following amounts: [Handwritten notations omitted]

(a) The amount of guaranty stock required by Chapter 33.48, Section .030 of the Revised Code of Washington relating to guaranty stock savings and loan associations.

(b) An amount equal to 2% of the first $10,000,000 of withdrawable shares, plus 1% of all withdrawable shares in excess of $10,000,000; provided, however, that with respect to the requirements of this subsection (b) only, undivided profits may be earmarked as a substitute for stock up to 50% of the stock requirement, but not in excess of $50,000, for a period of time not to exceed three years, and all undivided profits so earmarked shall be subject to all the limitations which apply to stock; and provided further that whenever the aggregate amount of guaranty stock is less than the requirements herein specified, cash dividends, computed on the latest fiscal year end book value of the guaranty stock, shall not be higher than the lowest rate paid on withdrawable share accounts.

Section 2: Guaranty stock shall be paid for in cash at par and shall not be eligible for loans from the association. Guaranty stock shall not be subject to withdrawal except upon liquidation or dissolution and until all claims

of creditors and the claims of all other classes of members first shall have been fully paid. Guaranty stockholders shall participate in distribution of assets upon liquidation or dissolution after payment has been made in full to all creditors and to all holders of withdrawable capital. No dividends shall be declared on guaranty stock until the reserves required by law and the total of the guaranty stock, undivided profits and all reserves available for losses, less all estimated and determined losses resulting from the depreciation in value of the assets is equal to 5% of the savings. Subject to the laws of the State of Washington, guaranty stock shall be entitled to such rate of dividend, if earned, as fixed by the board and stock dividends may be declared and issued by the board at any time, payable from otherwise surplus and undivided profits, provided that no dividend shall be paid or credited upon shares of guaranty stock for any period in which the association shall not have declared and paid dividends upon withdrawable savings.

ARTICLE III

CLASSES OF SAVINGS ACCOUNTS

Section 1: The association is authorized to issue the following classes of savings accounts:

(a) SAVINGS ACCOUNTS which represent the usual type of savings on which payments may be made at any time.

(b) INSTALLMENT ACCOUNTS on which payments shall be made at regularly designated intervals until such installments, together with dividends credited, shall accumulate to an agreed amount.

(c) FULLY PAID ACCOUNTS upon which a single payment shall be paid at the time of subscription,

such accounts may be issued only in multiples of $100.

(d) JUVENILE ACCOUNTS which are those issued in the name of minors. Such accounts may be withdrawn at any time regardless of the status as to the withdrawal of other classes of accounts. Juvenile savings shall receive the same rate of dividend as is paid on savings accounts.

(e) SCHOOL SAVINGS ACCOUNTS. School savings shall receive the same rate of dividend as is paid on savings accounts.

(f) Capital in the form of savings deposits, shares, or other accounts for fixed, minimum or indefinite periods of time (all of which are referred to in this section as savings accounts and all of which shall have the same priority upon liquidation) as are authorized by its bylaws, and may issue such passbooks, time certificates of deposit, or other evidence of savings accounts. (amended 6/19/69)

Section 2: All classes of accounts except FULLY PAID ACCOUNTS shall be represented by a passbook. FULLY PAID ACCOUNTS shall be represented by a Fully Paid Certificate.

Section 3: The board of directors may prescribe the rules and regulations under which savings of Classes (b), (c), (d) and (e) are received.

Section 4: All classes of accounts shall be transferable only upon the books of the association and upon proper application by the transferee and upon acceptance of the transferee as a member upon terms approved by the board of directors.

ARTICLE IV

DIVIDENDS

Section 1: Except as provided in Section 2 of this article, all classes of savings accounts shall participate equally in dividends pro-rata to paid in value, including credited dividends.

Section 2: The board of directors may provide for bonus dividend payments under a bonus plan.

Section 3: The association shall not be required to pay dividends on balances of less than $5.00, or on dormant accounts as defined in Section 33.20.130 of the Revised Code of Washington, Laws of 1945, Chapter 235, Section 53.

Section 4: Dividends shall be distributed ratably to all savings members as determined by the board of directors and in accordance with the Laws of the State of Washington. The board may fix a date not later than the 10th of the month for determining the date that investments on the savings accounts shall share in earnings.

Section 5: This savings and loan association may classify its savers or depositors according to the character, amount, frequency or duration of their dealing with the association and may regulate the earnings in such manner that each saver or depositor shall receive the same returnable portion of dividends or interest as all others of his class. (amended 6/19/69)

ARTICLE V

WITHDRAWALS

Section 1: Savings, together with dividends credited thereon, shall be repaid upon request of the member and

presentation of passbook or certificates. Every request for withdrawal shall be in writing. If, in the judgment of the board, circumstances warrant deferrment (sic) of the payment of withdrawals to a later date, thereafter withdrawals shall be paid proportionately, on a percentage basis, to all members requesting withdrawal until full withdrawal requests are paid to all members. The board shall, however, have the right in its discretion, where need is shown, to pay not exceeding $100.00 to any account holder in one month. Every member shall participate in the dividends of the association until his withdrawal is paid.

ARTICLE VI

FINES, FEES AND PENALTIES

Section 1: The association shall not directly or indirectly charge any membership, admission, repurchase, withdrawal, or other fee or sum of money for the privilege of becoming, remaining or ceasing to be a savings member of the association.

ARTICLE VII

EXPENSES

Section 1: Expenses must be budgeted and limited according to the laws of the State of Washington. Operating expenses shall include salaries, wages, office rent, operating expenses of quarters actually occupied by the association, advertising, printing, stationery, postage, telephone, telegrams, donations, contributions to employees' pension or retirement plan, insurance premiums, appraisal expense, dues to civic organizations, also to state and national savings and loan leagues, expenses of attending meetings, and other like expenses. "Operating expenses"

as used in this connection shall not be construed to include taxes, assessments, repair or insurance on real estate owned other than Home Office Building, or commissions on the sale of real estate, or any interest which the association may have paid or become liable to pay, expenses of foreclosures, suits or other bona fide litigations, or charges for state license fees.

ARTICLE VIII

LOANS AND INVESTMENTS

Section 1: The funds of the association may be loaned or invested as the board of directors may direct, and as prescribed by the laws of the State of Washington.

ARTICLE IX

RESERVES

Section 1: There shall be established certain reserves as prescribed by the laws of the State of Washington, and such others as the board at its discretion may prescribe.

ARTICLE X

VOTING AND PROXIES

Section 1: In consideration of all questions requiring action by the members, each holder of a savings account shall be permitted to cast one vote for each $100 of the participation value of his savings accounts and owners of guaranty stock shall be entitled to one vote for each share of stock, for which such voting rights shall not be subject to cumulative voting. A borrowing member shall be permitted, as a borrower, to cast one vote, and to cast

the number of votes to which he may be entitled as the holder of a savings account. Voting may be by proxy. A majority of all votes cast at any meeting of members shall determine any question.

ARTICLE XI

MEETING OF MEMBERS

Section 1: The annual meeting of the members shall be held at the office of the association on the fourth Thursday of January of each year at the hour of 4 o'clock P.M. If the aforesaid date falls on a legal holiday, then the said meeting shall be held on the next day not a legal holiday at the same place and time. Special meetings may be called by the board of directors stating the time, place and purpose of the meeting. Any number of members present greater than a majority of the board shall constitute a quorum.

ARTICLE XII

DIRECTORS

Section 1: The business and affairs of the association shall be managed and controlled by a board of directors of nine members, a majority of which shall not be officers or employees of the association. A majority of the board of directors shall be the owners of guaranty stock in the minimum amounts required by law for directors owning withdrawable savings. (amended 4/20/72)

Section 2: Directors shall be elected for a period of three (3) years, and in such manner that approximately one-third of the directors are elected each year.

Section 3: Vacancies in the board of directors shall be filled by vote of the members at the annual meetings

or at a special meeting called for the purpose. The board of directors may fill vacancies occurring on the board, such appointees to serve until the next annual meeting of the members.

Section 4: Meetings of the board shall be held not less than once each month, at a time to be set by resolution of the board.

Section 5: A majority of the board shall constitute a quorum for board meetings.

ARTICLE XIII

OFFICERS

Section 1: The officers of the association, elected by the board, shall be a president, one or more vice presidents, a secretary, treasurer, and such additional officers as the board may from time to time determine. The offices of secretary and treasurer may be held by the same person and a vice president may also be either the secretary or treasurer or secretary-treasurer. In the absence of designation of powers and duties by the board, the officers shall have such powers and duties as generally pertain to their respective offices.

ARTICLE XIV

POWERS OF THE BOARD OF DIRECTORS

The board of directors shall have the power:

Section 1: To appoint and remove the members of an executive committee (made of all members of the board, which committee shall have and exercise the power) of the board of directors between meetings of the board of directors and whose action shall be subject to approval and ratification of the board at the next subsequent meeting.

Section 2: To appoint and remove by resolution, the members of such committees as may be deemed necessary and prescribe the duties thereof.

Section 3: To fix the compensation of directors, officers and employees.

Section 4: To extend leniency and indulgence to borrowing members who are in distress, and generally to compromise and settle any debts and claims, or order mortgages or contracts foreclosed.

Section 5: To limit or reject the acceptance of savings.

Section 6: To exercise any and all of the powers of the association not expressly reserved by the articles of incorporation and by-laws to the members.

ARTICLE XV

AUTHORITY

Section 1: The association shall have the authority by resolution of the board of directors to become a member of the Federal Home Loan Bank and may purchase, own, vote or sell stock in, or act as fiscal agent for, or otherwise participate in any authorized state, or Federal agency, and to apply for and accept insurance of accounts by the Federal Savings and Loan Insurance Corporation, and to pay the premiums for such insurance.

ARTICLE XVI

CONFORMITY

Section 1: Any article or provision of these by-laws in conflict with the laws of the State of Washington pertaining to savings and loan associations shall be deemed amended to conform therewith, and any matters relating to authority, control, management or operation of this savings and loan association, or any privileges granted to savings and loan associations by the law, but not specifically provided for in these by-laws, shall be carried out, granted and exercised according to the provisions of the laws of the State of Washington, and the Savings and Loan Act of 1945 as now in effect or hereafter amended.

ARTICLE XVII

AMENDMENTS

Section 1: The members may amend the articles of incorporation of the association in accordance with, and subject to the Savings and Loan Laws of the State of Washington and the approval of the Supervisor. (amended 1/26/67)

Section 2: These by-laws may be amended by the members or board of directors if in accordance with the Savings and Loan Laws of the State of Washington and approved by the Supervisor. (amended 1/26/67)

EXHIBIT 5-E

Official Charter and Bylaws of Citizens Federal Savings and Loan Association

CHARTER K (REV.)

1. Corporate title—The full corporate title of the Federal association hereby chartered is Citizens Federal Savings and Loan Association of Seattle.

2. Office—The home office shall be located at Seattle, in the County of King, State of Washington.

3. Objects and powers—The objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economical financing of homes; and, in the accomplishment of such objects, it shall have perpetual succession and power: (1) To act as fiscal agent of the United States when designated for that purpose by the Secretary of the Treasury, under such regulations as he may prescribe, and shall perform all such reasonable duties as fiscal agent of the United States as he may require and to act as agent for any other instrumentality of the United States when designated for that purpose by any such instrumentality; (2) To sue and be sued, complain and defend in any court of law or equity; (3) To have a corporate seal, affixed by imprint, facsimile or otherwise; (4) To appoint officers and agents as its business shall require, and allow them suitable compensation; (5) To adopt bylaws not inconsistent with the Constitution or laws of the United States and rules and regulations adopted thereunder and this charter; (6) To raise its capital, which shall be unlimited, by accepting payments on savings accounts representing share interests in the association; (7) To borrow money; (8) To lend and otherwise invest its funds; (9) To wind up and dissolve, merge, consolidate, convert, or reorganize; (10) To purchase, hold, and convey real and personal estate consistent with its objects, purposes, and powers; (11) To mortgage or lease any real and personal estate and take such property by gift, devise or bequest; and (12) To exercise all

powers conferred by law. In addition to the foregoing powers expressly enumerated, this association shall have power to do all things reasonably incident to the accomplishment of its express objects and the performance of its express powers. It shall exercise its powers in conformity with all laws of the United States as they now are, or as they may hereafter be amended, and with all rules and regulations which are not in conflict with this charter now or hereafter made thereunder. Notwithstanding and without regard to any other provisions of this charter, the association may raise capital in the form of such savings deposits or other accounts as are authorized by regulations made by the Federal Home Loan Bank Board, and the holders of such deposits or accounts shall, to such extent as may be provided by such regulations, be members of the association and shall have such voting rights and such other rights as are thereby provided, and it may, to such extent as said Board may authorize by regulation or by other action authorized or under Federal statute, exercise any authority to borrow money, to give security, or to issue notes, bonds, debentures, or other obligations, or other securities, provided by or under any provision of Federal statute as from time to time in effect.

4. Members—All holders of the association's savings accounts and all borrowers therefrom are members. In the consideration of all questions requiring action by the members of the association, each holder of a savings account shall be permitted to cast one vote for each $100, or fraction thereof, of the withdrawal value of his account. A borrowing member shall be permitted, as a borrower, to cast one vote, and to cast the number of votes to which he may be entitled as the holder of a savings account. No

member, however, shall cast more than 400 votes. Voting may be by proxy. Any number of members present at a regular or special meeting of the members shall constitute a quorum. A majority of all votes cast at any meeting of members shall determine any question. The members who shall be entitled to vote at any meeting of the members shall be those owning savings accounts and borrowing members of record on the books of the association at a date set by the board of directors and not less than 20 days and not more than 50 days prior to the date of such meeting. The number of votes which each member shall be entitled to cast at any meeting of the members shall be determined from the books of the association as of such record date. Any member at such record date who ceases to be a member prior to such meeting shall not be entitled to vote thereat. All savings accounts shall be nonassessable.

5. Directors—The association shall be under the direction of a board of directors of not less than 5 nor more than 15, as fixed in the association's bylaws or, in the absence of any such bylaw provision, as from time to time expressly determined by resolution of the association's members. Each director of the association shall be a member of the association, and a director shall cease to be a director when he ceases to be a member. Directors of the association shall be elected by its members by ballot: *Provided,* That in the event of a vacancy in the directorate, including vacancies created by an increase in the number of directors, the board of directors may fill such vacancy, if the members of the association fail so to do, by electing a director to serve until the next annual meeting of the members. Directors shall be elected for periods of 3 years and until their successors are elected and quali-

fied, but provision shall be made for the election of approximately one-third of the board of directors each year.

6. Withdrawals—Each withdrawal from a savings account shall be governed by this section except to the extent that a member's account book or other written evidence of the member's savings account contains additional requirements in accordance with regulations made by the Federal Home Loan Bank Board. The association shall have the right to pay the withdrawal value of its savings accounts at any time upon application therefor and to pay the holders thereof the withdrawal value thereof. Upon receipt of a written request from any holder of a savings account of the association for the withdrawal from such account of all or any part of the withdrawal value thereof, the association shall within 30 days pay the amount requested: *Provided,* That if the association is unable to pay all withdrawals requested at the end of 30 days from the date of such requests, it shall then proceed in the following manner while any withdrawal request remains unpaid for more than 30 days:

> Withdrawal requests shall be paid in the order received and if any holder of a savings account or accounts has requested the withdrawal of more than $1,000, he shall be paid $1,000 in order when reached and his withdrawal request shall be charged with such amount as paid and shall be renumbered and placed at the end of the list of withdrawal requests, and thereafter, upon again being reached, shall be paid a like amount, but not exceeding the withdrawal value of his savings account, and until such withdrawal request shall have been paid in full, shall continue to be so paid, renumbered, and replaced at the end of the withdrawal requests on file: *Provided,* That when any such request is reached for payment, the association shall so advise the holder of such savings account by registered mail to his last address as recorded on the books of the association and, unless such holder shall apply in person or in writing for the payment of such withdrawal request within 30 days from the date of the mailing of such notice, no payment on account of such withdrawal request shall be made and such request shall be cancelled: *And provided further,* That the board of directors shall have absolute right to pay on an equitable basis an amount not exceeding $200 to any holder of a savings account or accounts in any calendar month and without regard to any other provision of this section.

When the association is unable to pay all withdrawal requests within a period not exceeding 30 days from the date of receipt of written request therefor it shall allot to the payment of such requests the remainder of the association's receipts from all sources after deducting from total receipts appropriate amounts for expenses, required payments on indebtedness, earnings distributable in cash to holders of savings accounts, and a fund for general corporate purposes equivalent to not more than 20 percent of the association's receipts from holders of its savings accounts and from its borrowers. Holders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid and shall not become creditors.

7. Redemption—At any time sufficient funds are on hand, the association shall have the right to redeem, by lot or otherwise as the board of directors may determine, all or any part of any of its savings accounts on June 30 or December 31, by giving 30 days' notice of such redemption by registered mail addressed to the holder of each such savings account at his last address as recorded on

the books of the association. The association may not redeem any of its savings accounts when there is an impairment of its capital or when it has any request for withdrawal which has been on file and unpaid for more than 30 days. The redemption price of each savings account redeemed shall be the full value thereof, as determined by the board of directors, but in no event shall the redemption price be less than the withdrawal amount of such savings account. If a savings account which is redeemed is entitled to participate in any reserve for bonus, the amount in such reserve for bonus which is properly allocable to such savings account shall be paid as part of the redemption price thereof. If any notice of redemption shall have been duly given, and if the funds necessary for such redemption shall have been set aside so as to be and to continue to be available for that purpose, earnings upon such account shall cease to accrue from and after the date specified as the redemption date and all rights with respect to each such account shall forthwith, after such redemption date, terminate, except only the right of the holder of record of such savings account to receive the redemption price thereof without earnings.

8. Loans and investments—The association may make any loan or investment authorized by statute and the rules and regulations made by the Federal Home Loan Bank Board and in effect on August 15, 1949; it may make such additional loans and investments as may thereafter be authorized by amendments of the said rules and regulations.

9. Power to borrow—The association may borrow money in an aggregate amount not exceeding one-half of

its assets. Notwithstanding the foregoing limitation, the association may, with prior approval by the Board, borrow from a Federal Home Loan Bank or from any Federal agency or instrumentality without limitation, upon such terms and conditions as may be required by such bank or agency. The association may pledge and otherwise encumber any of its assets to secure its debts.

10. Reserves, surplus, and distribution of earnings—The association shall maintain general reserves for the sole purpose of meeting losses; such reserves shall include the reserve required for insurance of account. Any losses may be charged against general reserves. If and whenever the general reserves of the association are not equal to at least 10 percent of its capital, it shall, as of June 30 and December 31 of each year, credit to such reserves an amount equivalent to at least 5 percent of its net earnings for the 6 months' period, or such amount as may be required by the Federal Savings and Loan Insurance Corporation, whichever is greater, until such reserves are equal to at least 10 percent of the association's capital. As of June 30 and December 31 of each year, after payment or provision for payment of all expenses, credits to general reserves and such credits to surplus as the board of director may determine, and provision for bonus on savings accounts as authorized by regulations made by the Federal Home Loan Bank Board, the board of directors of the association shall cause the remainder of the net earnings of the association for the 6 months' period to be distributed promptly on its savings accounts, ratably, as declared by the board of directors, to the withdrawal value thereof; in lieu of or in addition to such net earnings, any of the association's surplus funds may be likewise distributed.

Such net earnings shall be credited to savings accounts or paid, as directed by the owner. All holders of savings accounts shall participate at the same rate and on the same basis in the distribution of earnings: *Provided,* That the association is not required to distribute earnings on short-term savings accounts or on accounts of $10 or less. Except as provided above, earnings shall be declared on all savings accounts of record at the close of each such 6 months' period, on the withdrawal value of each such account at the beginning of the said 6 months' period, plus the payments made thereupon during such period (less amounts withdrawn and, for purposes of participation in earnings, deducted from the latest previous payments), computed at the declared rate for the time invested, determined as provided below. The date of investment shall be the date of actual receipt of such payments by the association, unless the board of directors fixes a date, not later than the tenth of the month, for determining the date of investment of payments on savings accounts or designated classes thereof. Payments, affected by such determination date, received by the association on or before such determination date, shall receive earnings as if invested on the first of such month. Payments, affected by such determination date, received subsequent to such determination date, shall receive earnings as if invested on the first day of the next succeeding month. Notwithstanding any other provision of its charter, the association may distribute net earnings on its savings accounts on such other basis and in accordance with such other terms and conditions as may from time to time be authorized by regulations made by the Federal Home Loan Bank Board. All holders of savings accounts of the association shall be entitled to equal distribution of assets, pro rata to the value of their savings

accounts, in the event of voluntary or involuntary liquidation, dissolution, or winding up of the association.

11. Amendment of charter—No amendment, addition, alteration, change or repeal of this charter shall be made unless such proposal is made by the board of directors of the association, and submitted to and approved by the Federal Home Loan Bank Board, and is thereafter submitted to and approved by the members at a legal meeting. Any amendment, addition, alteration, change, or repeal so acted upon and approved shall be effective, if filed with and approved by the Federal Home Loan Bank Board, as of the date of the final approval of, or as fixed by, the members.

Issued at Washington, D.C., this 9th day of February 1937.

FEDERAL HOME LOAN BANK BOARD

By ,Chairman

(Signed)

Attest:

R. L. Nagle, Secretary
(Signed)

BYLAWS

1. Annual meetings of members—The annual meetings of the members of the association for the election of directors and for the transaction of any other business of the association shall be held at its home office at 2 o'clock in the afternoon on the fourth Thursday in September of each year, if not a Sunday or a legal holiday, or, if a Sunday or a legal holiday then on the next succeeding day not a Sunday or legal holiday. The annual meeting may be held at such other time on such day or at such other place in the same community as the board of directors may de-

termine. At each annual meeting, the officers shall make a full report of the financial condition of the association and of its progress for the preceding year, and shall outline a program for the succeeding year. Annual meetings of the members shall be conducted in accordance with Roberts' Rules of Order. In lieu of the date specified in the first sentence of this subparagraph, such annual meeting in any year may be held on another date which is not a Sunday or a legal holiday and which is not earlier than 15 days after the annual closing of the association's books, and not later than 3 months and 15 days after such closing of the Association's books, if the following requirements are met:

(i) The board of directors determines the date by resolution adopted at least 2 months before the annual closing of the books for the year preceding the year in which the annual meeting is to be held; and

(ii) Notice of said date is continuously posted in a conspicuous place in each of the offices of the association during the 50 days immediately preceding the date so determined.

2. Special meetings of members—Special meetings of the members of the association may be called at any time by the president or the board of directors, and shall be called by the president, a vice president, or the secretary upon the written request of members holding of record in the aggregate at least one-tenth of the capital of the association. Such written request shall state the purposes of the meeting and shall be delivered at the home office of the association addressed to the president. Special meetings of the members shall be conducted in accordance with Roberts' Rules of Order.

3. Notice of meeting of members—(a) Notice of each annual meeting shall be either published once a week for the two successive calendar weeks (in each instance on any day of the week) immediately prior to the week in which such annual meeting shall convene, in a newspaper printed in the English language and of general circulation in the city or county in which the home office of the association is located, or mailed postage prepaid at least 15 days and not more than 30 days prior to the date on which such annual meeting shall convene to each of its members of record at his last address appearing on the books of the association. Such notice shall state the name of the association, the place of the annual meeting and the time when it shall convene. A similar notice shall be posted in a conspicuous place in each of the offices of the association during the 14 days immediately preceding the date on which such annual meeting shall convene. If any member, in person or by attorney thereunto authorized, shall waive in writing notice of any annual meeting of members, notice thereof need not be given to such member.

(b) Notice of each special meeting shall be either published once a week for the two consecutive calendar weeks (in each instance on any day of the week) immediately prior to the week in which such special meeting shall convene, in a newspaper printed in the English language and of general circulation in the city or county in which the home office of the association is located, or mailed postage prepaid at least 15 days and not more than 30 days prior to the date on which such special meeting shall convene to each of its members of record at his last address appearing on the books of the association. Such notice shall state the name of the association, the purpose or purposes for which the meeting is called, the place of

the special meeting and the time when it shall convene. A similar notice shall be posted in a conspicuous place in each of the offices of the association during the 14 days immediately preceding the date on which such special meeting shall convene. If any member, in person or by attorney thereunto authorized, shall waive in writing notice of any special meeting of members, notice thereof need not be given to such member.

4. Meetings of the board of directors—The board of directors shall meet regularly without notice at the home office of the association at least once a month at the hour and date fixed by resolution of the board of directors. Provided, that the place of meeting may be changed by the directors. Special meetings of the board of directors may be held at any place in the territory in which the association may make loans specified in a notice of such meeting and shall be called by the secretary upon the written request of the president, or of three directors. All special meetings shall be held upon at least 3 days' written notice to each director unless notice be waived in writing before or after such meeting. Such notice shall state the place, time, and purposes of such meeting. A majority of the directors shall constitute a quorum for the transaction of business. The act of a majority of the directors present at any meeting at which there is a quorum shall be the act of the board of directors. All meetings of the board of directors shall be conducted in accordance with Roberts' Rules of Order.

5. Officers, employees and agents—Annually at the meeting of the board of directors of the association next following the annual meeting of the members of the association, the board of directors shall elect a president, one or more vice presidents, a secretary, and a treasurer. The

offices of secretary and treasurer may be held by the same person, and a vice president may also be either the secretary or the treasurer. The board of directors may appoint such additional officers and such employees and agents as it may from time to time determine. The term of office of all officers shall be one year or until their respective successors are elected (or appointed) and qualified. However, the board of directors may authorize the association to enter into an employment contract with any officer in accordance with regulations of the Federal Home Loan Bank Board; but no such contract shall impair the right of the board of directors to remove any officer at any time. In the absence of designation from time to time of powers and duties by the board of directors, officers shall have such powers and duties as generally pertain to their respective offices.

6. Resignation of directors—Any director may resign at any time by sending a written notice of such resignation to the office of the association delivered to the secretary. Unless otherwise specified therein, such resignation shall take effect upon receipt thereof by the secretary. More than three consecutive absences from regular meetings of the board of directors, unless excused by resolution of the board of directors, shall automatically constitute a resignation, effective when such resignation is accepted by the board of directors.

7. Powers of the board—The board of directors shall have power—

(a) To appoint and remove by resolution the members of an executive committee, the members of which shall be directors, which committee shall have and exercise the powers of the board of directors between the meetings of the board of directors;

(b) To appoint and remove by resolution the members of such other committees as may be deemed necessary and prescribe the duties thereof;

(c) To fix the compensation of directors, officers, and employees; and to remove any officer or employee at any time with or without cause;

(d) To extend leniency and indulgence to borrowing members who are in distress and generally to compromise and settle any debts and claims;

(e) To limit payments on capital which may be accepted;

(f) To reject any application for savings accounts or memberships; and

(g) To exercise any and all of the powers of the association not expressly reserved by the charter to the members.

8. Execution of instruments, generally—All documents and instruments or writings of any nature shall be signed, executed, verified, acknowledged, and delivered by such officers, agents, or employees of the association or any one of them and in such manner as from time to time may be determined by resolution of the board of directors. All notes, drafts, acceptances, checks, endorsements, and all evidence of indebtedness of the association whatsoever shall be signed by each officer or officers or such agent or agents of the association and in such manner as the board of directors may from time to time determine. Endorsements for deposit to the credit of the association in any of its duly authorized depositories shall be made in such manner as the board of directors may from time to time determine. Proxies to vote with respect to shares or accounts

of other associations or stock of other corporations owned by or standing in the name of the association may be executed and delivered from time to time on behalf of the association by the president or a vice president and the secretary or an assistant secretary of the association or by any other person or persons thereunto authorized by the board of directors.

9. Savings account certificates—Such officers, employees or agents (as provided in §545.1-4(a) of Chapter 5 of Title 12 of the Code of Federal Regulations) as may be designated by the board of directors shall deliver to each person upon the initial payment on his savings account in the association an account book or other written evidence of such account.

10. Seal—The seal shall be two concentric circles between which shall be the name of the association. The year of incorporation, the word "incorporated", or an emblem may appear in the center.

11. Amendment—These bylaws may be amended at any time by a two-thirds affirmative vote of the board of directors, or by a vote of the members of the association. Each and every amendment shall be subject to the approval of the Federal Home Loan Bank Board, and shall be ineffective until such approval shall be given; *Provided,* That without the approval of the Federal Home Loan Bank Board, section 1 of the bylaws may be amended so that the time of day for convening the annual meeting may be fixed at any hour not earlier than 10 a.m. or later than 9 p.m., and a section providing for a bonus may be added or repealed as provided in the rules and regulations for the Federal Savings and Loan System.

AMENDMENTS TO BYLAWS

(a) Nominating committee—The president, at least 30 days prior to the date of each annual meeting, shall appoint a nominating committee of three persons who are members of the association. Such committee shall make nominations for directors in writing, and deliver to the secretary such written nominations at least 15 days prior to the date of the annual meeting, which nominations shall forthwith be posted in a prominent place in the home office for the 15 days' period prior to the date of the annual meeting. Provided such committee is appointed and makes such nominations, no nominations for directors except those made by the nominating committee shall be voted upon at the annual meeting unless other nominations by members are made in writing and delivered to the secretary of the association at least 10 days prior to the date of the annual meeting, which nominations shall forthwith be posted in a prominent place in the home office for the 10 days' period prior to the date of the annual meeting. Ballots bearing the names of all persons nominated by the nominating committee and by other members prior to the annual meeting shall be provided for use by the members at the annual meeting. If at any time the president shall fail to appoint such nominating committee, or the nominating committee shall fail or refuse to act at least 15 days prior to the annual meeting, nominations for directors may be made at the annual meeting by any member and shall be voted upon.

(b) New business—Any new business to be taken up at the annual meeting, including any proposal to increase or decrease the number of directors of the association, shall be stated in writing and filed with the secretary of

the association on or before thirty (30) days before the date of the annual meeting, and all business so stated, proposed and filed shall be considered at the annual meeting, but no other proposal shall be acted upon at the annual meeting. Any member may make any other proposal at the annual meeting and the same may be discussed and considered, but unless stated in writing and filed with the secretary thirty (30) days before the meeting such proposal shall be laid over for action at an adjourned, special or regular meeting of the members taking place thirty (30) days or more thereafter. This provision shall not prevent the consideration and approval or disapproval at the annual meeting of the reports of officers and committees, but in connection with such reports no new business shall be acted upon at such annual meeting unless stated and filed as herein provided.

(c) Voting by proxy—Voting at any annual or special meeting of the members may be made by proxy, it being provided that no proxies shall be voted at any meeting unless such proxies shall have been placed on file with the secretary of the association, for verification, at least five (5) days prior to the date on which such meeting shall convene.

(d) Number of directors—The number of directors of the association shall be 7.

(e) Bonus on savings accounts—The board of directors shall have exclusive power to obligate the association to distribute a bonus on savings accounts, and to terminate such obligation, in accordance with rules and regulations made by the Federal Home Loan Bank Board.

EXHIBIT 6-F

PLAN FOR MERGER

This plan for merger dated this 7th day of November, 1975, between Citizens Federal Savings & Loan Association of Seattle, a federal savings & loan association, hereinafter called Citizens, and Commerce Savings & Loan Association, hereinafter called Commerce.

Citizens is a Federally Chartered (Charter K Revised) Savings and Loan Association, organized and existing under the laws of the United States and under regulations of the Federal Home Loan Bank Board.

Commerce is a Capital Stock Association organized and existing under the laws of the State of Washington, having been incorporated and having currently 211,133 shares, if all existing options are exercised.

The Boards of Directors of Citizens and Commerce, deeming that it is to the advantageous business interest of both associations to merge so that the surviving association will be enabled to receive the benefits of greater efficiency and ability to compete successfully in the market which is conferred by greater size and number of offices, and deeming, after investigation, that the values are fair and reasonable as set forth herein for the exchange of shares of Commerce stock for deposits (later to be defined) in the resulting Association; and deeming that such merger will result in a genuine continuity of interest for the stockholders and shareholders of Commerce in the surviving association and the respective Board of Directors of Citizens and Commerce having previously passed resolutions to the above effect;" (sic)

NOW, THEREFORE, in consideration of the premises of the mutual covenants and agreements herein set forth and for the purpose of prescribing the terms and conditions of such merger, the parties hereto covenant and agree as follows:

1. *Merger.* Commerce shall have merged with and into Citizens, which shall be the surviving association and which shall have the name provided in paragraph 2 below, upon the occurrence of the following events:

(a) This plan for merger shall have been adopted and approved by such action of Commerce and Citizens as shall comply with the requirements of the laws of the State of Washington, and all applicable federal laws, the regulations of the Federal Home Loan Bank Board and of the State of Washington respectively, and that fact shall have been certified by the respective secretaries of each association under their respective corporate seals. It is agreed that this Plan of Merger shall be approved by Commerce by vote of at least 51% of the votes of those properly holding voting rights, and approved by Citizens by a majority vote of its Board of Directors, if such a mode of approval is in accordance with the regulations of the Federal Home Loan Bank Board. It is the intent and purpose of the parties that this shall be a tax-free merger under the terms of §368(a) (1) (A) of the Internal Revenue Code.

(b) This agreement, so adopted and certified shall have been signed, acknowledged and filed, all as required by the provisions of Chapter 33.40.010 of the Revised Code of Washington, which provides for merger between business entities such as Citizens and Commerce, and

(c) Four copies of this merger agreement properly executed in the name of the respective associations and four certified copies of such portions of the minutes of the meetings of the respective boards of directors as related to the consideration and approval of this Plan of Merger, four copies of the merger application shall have been submitted for approval to the Federal Home Loan Bank Board; and the Federal Home Loan Bank Board and/or such other federal or state agencies as shall be appropriate, shall have approved this merger;

(d) The Federal Home Loan Bank Board shall have approved the home office of Citizens, 1409 Fifth Avenue, Seattle, Washington 98101, as the address of the home office of the surviving association.

(e) The Federal Home Loan Bank Board shall have approved the four offices of Commerce as branches of the surviving Association, to wit:

Downtown Tacoma Office
1015 Pacific Avenue
Tacoma, Washington

Tacoma Mall Office
381 Tacoma Mall
Tacoma, Washington

Seventy-Second Street Office
317 South 72nd Street
Tacoma, Washington

Gig Harbor Office
7109 Pioneer Way
Gig Harbor, Washington

(f) On the effective date of the merger, all stock of Commerce shall be exchanged for insured deposits in the surviving Association pursuant to the schedule in Exhibit A attached hereto.

Thereupon, Commerce shall be deemed to have merged with and into Citizens which shall survive the merger and which shall have the name provided in paragraph 2 hereof.

The single association which shall so survive the merger is hereinafter sometimes called the surviving association; Citizens and Commerce are hereinafter sometimes called the constituent associations; and the date and time when the constituent associations shall merge and become the surviving association are hereinafter referred to as the "effective date of the merger".

2. *Names and purposes of the surviving association.* The name of the surviving association shall be Citizens Federal Savings & Loan Association of Seattle. The purposes for which the surviving association is formed and the nature of the business to be transacted by it shall be as set forth in the charter of Citizens on the effective date of the merger.

3. *By-laws of surviving association.* On the effective date of the merger, the by-laws of Citizens, as heretofore amended, shall be the by-laws of the surviving association until the same shall be altered, amended, or repealed, or until new by-laws shall be adopted, by proper procedure according to federal and state law and the regulations of the Federal Home Loan Bank Board.

4. *Location of home office and branch offices.* The home office of the surviving association and the branch offices shall be as follows:

MAIN OFFICE:
1409 Fifth Ave.
Seattle, WA 98101

BELLEVUE OFFICE:
320 - 108th N.E.
Bellevue, WA 98004

BURIEN OFFICE:
120 S.W. 160th
Seattle, WA 98166

CAPITOL HILL OFFICE:
225 Broadway East
Seattle, WA 98102

QUEEN ANNE OFFICE:
1600 Queen Anne North
Seattle, WA 98109

RICHMOND HIGHLANDS OFFICE:
18200 Midvale N.
Seattle, WA 98133

SOUTHCENTER OFFICE:
903 Southcenter Mall
Seattle, WA 98188

JUANITA OFFICE:
13633 - 100th N.E.
Kirkland, WA 98033

RENTON OFFICE:
201 Williams Ave.
Renton, WA 98055

RENTON HIGHLANDS OFFICE:
2833 N.E. Sunset Blvd.
Renton, WA 98055

LAKEWOOD OFFICE:
100th St. S.W. Bridgeport Way
Tacoma, WA 98499

SPANAWAY OFFICE:
14820 Pacific Ave. S.
Tacoma, WA 98444

DOWNTOWN TACOMA OFFICE:
1015 Pacific Ave.
Tacoma, WA 98402

TACOMA MALL OFFICE:
381 Tacoma Mall
Tacoma, WA 98409

TACOMA HIGHLANDS OFFICE:
6902 - 6th Ave.
Tacoma, WA 98406

SEVENTY-SECOND STREET OFFICE:
317 South 72nd Street
Tacoma, WA 98408

GIG HARBOR OFFICE
7109 Pioneer Way
Gig Harbor, WA 98335

5. *Directors and officers of the surviving association.* The Board of Directors of the surviving association shall consist of the present six directors of Citizens who shall hold office and be subject to re-election pursuant to the by-laws of the surviving association. The respective names, places of residence, and addresses of such directors are as follows:

Edgar E. Cushing, Chairman of the Board
2100 Third Ave., Apt. 1702, Seattle, WA 98121

John K. Aldrich, Dean of Instruction
North Seattle Community College
2415 Monta Vista Place West, Seattle, WA 98199

Wendell H. Broyles, Executive Vice-President
King County Medical Blue Shield
1610 - 85th N.E., Bellevue, WA 98004

John W. Rumsey, President
Rumsey & Company, General Contractors
C. S. Apartments, LTD., 2979 Kalakaua Ave.,
Honolulu, Hawaii 98615

Duane L. Tewell, Partner
Elvidge, Veblen, Tewell, Bergmann & Taylor
1969 S.W. Hillcrest Road, Seattle, WA 98166

David P. Thompson, President
3135 Fairweather Place, Bellevue, WA 98004

(Victor E. Rabel, non-voting Director Emeritus,
Star Machinery Company)
1620 - 43rd East, Seattle, WA 98102

The principal officers of the surviving association, shall be the present principal officers of Citizens together with Harold Paulsen with such additions or changes as shall be made by proper authority. The offices, places of residence and post office addresses of such officers are as follows:

David P. Thompson, President
3135 Fairweather Place, Bellevue, WA 98004

Ronald O. Fogg, Sr. Vice-President
17205 - 2nd N.W., Seattle, WA 98177

C. E. McAllister, Sr. Vice-President & Secretary
17225 N.E. 15th Place, Bellevue, WA 98008

Harold Paulsen, Sr. Vice-President
3341 North Shirley
Tacoma, Washington 98407

John Webber, Jr., Sr. Vice-President
10403 Marine View Drive
Everett, WA 98204

Joseph B. Rogers, Vice-President
410 - 155th Ave. S.E., Bellevue, WA 98007

Lue A. Seil, Treasurer
11302 E. Riverside Dr., Bothell, WA 98011

6. All savings account holders in Commerce and Citizens shall, upon merger, become savings account holders in the surviving association, with all rights and privileges of membership, including, but not limited to:

(a) Voting rights pursuant to the charter and bylaws of the resulting Association.

(b) Accounts insured under the regulations of FSLIC.

(c) Interest on all qualifying accounts on day of deposit to day of withdrawal.

(d) Interest compounded continuously on all qualifying accounts and qualifying time certificates.

(e) Commerce and Citizens time certificates honored as to all terms by the surviving association.

7. *Continuity of business.* Between the date hereof and the effective date of the merger, Commerce will not, (except with the prior written consent of Citizens):

(a) Issue or sell any capital stock, bonds or other corporate securities;

(b) Make any dividend or other payment or distribution to its stockholders or purchase or redeem any shares of its capital stock. (This provision shall not affect the right of Commerce to issue stock pursuant to any existing option.)

It is understood and agreed that Commerce shall continue to conduct all business in its normal fashion. It is also understood and agreed that any unusual business matters will be handled by mutual consultation between Citizens and Commerce until the effective date of merger.

8. *Effect of merger.* On the effective date of merger, the surviving association shall possess all the rights, privileges, powers, franchises, trusts and fiduciary duties, powers and obligations of a public as well as of a private nature, and be subject to all of the restrictions, disabilities, and duties of each of the constituent corporations, and all

and singular, the rights, privileges, powers and franchises and trust and fiduciary rights, powers, duties and obligations of each of the constituent associations; and all property, real, personal and mixed and all debts due to either of the constituent corporations on whatever account, and all property rights, privileges, powers and franchises and all and every other interest shall be thereafter as effectually the property of the Surviving Association as they were of the respective constituent associations and the title to any real estate, whether vested by deed or otherwise, in either of the constituent associations shall not revert or be in any way impaired by reason of the merger;* provided, however, that all of the rights of creditors and all liens upon any property of either of the constituent associations shall be preserved unimpaired, and all debts, liabilities and duties of the respective constituent associations shall hence forth attach to the Surviving Association, and may be enforced against it to the same extent as if such debts, liabilities and duties had been incurred or contracted by the Surviving Association. *Tacoma Mall Corporation has the right to approve the name change and lease assignment pursuant to the Tacoma Mall lease.

9. *Further instruments.* Hereafter, as and when requested by the Surviving Association or by its successors or assigns, constituent association Commerce will execute and deliver or cause to be executed and delivered, all instruments of any kind, and will take or cause to be taken, such further action as the Surviving Association may deem necessary or desirable in order to vest in and confirm to the Surviving Association, title to, and possession of, all its property, rights, privileges, powers, franchises, and

otherwise to carry out the intent and purposes of this agreement.

10. On the effective date of the merger, all employees of Citizens and Commerce shall become employees of the Surviving Association. All pension and retirement plans of Citizens and all other plans, agreements, or arrangements of Citizens relating to its employees or any of them in force on the effective date of the merger shall be effective with respect to the Surviving Association and its employees in the same manner and on the same terms and conditions as applied previously to employees of Citizens. In the same manner, Surviving Association employees under age 65 who were also prior employees of Commerce shall become eligible and enrolled therein for all pension and retirement plans of the Surviving Association on the same basis, and with the same credit and rights for length of service, as Surviving Association employees who were prior employees of Citizens.

Upon consummation of the merger, the Surviving Association will enter into an employment agreement effective at that time with Harold Paulsen providing for a salary of at least $27,500 a year for a period of time consistent with the by-laws of the Surviving Association and the federal rules and regulations governing Federal Savings & Loan Associations.

11. *Conversion of securities and accounts on merger.* The manner of converting the stock and savings accounts of Commerce and the savings accounts of Citizens, to savings accounts in the Surviving Association is as follows:

(a) Each savings account of Citizens outstanding on the effective date of the merger shall remain out-

standing as one savings account of the same size in the Surviving Association.

(b) Each savings account of Commerce outstanding on the effective date of the merger shall remain outstanding as one savings account of the same size in the Surviving Association.

(c) Each share of capital stock of Commerce outstanding on the effective date of the merger and not owned by Commerce shall be converted on a ratio of one share of Commerce stock to a $12 deposit in a regular passbook savings account in the Surviving Association with said deposit not to be withdrawn for a period of one year. The Surviving Association shall grant to all prior shareholders of Commerce borrowing privileges against said resulting deposits at a rate 1½% above the passbook rate.

(d) On the effective date of the merger, all shares of capital stock of Commerce owned by Commerce or any shareholder of Commerce shall immediately be retired and have no further existence subject to the provisions of this merger agreement pertaining to exchange of stock for time-saving share certificates or regular savings accounts. The assets and liabilities of Commerce, as of the effective date of this merger, shall be placed upon the books of the Surviving Association at book value.

12. *Representations by Commerce.*

(a) Commerce represents that its accounts are insured by Federal Savings & Loan Insurance Corporation according to all prevailing regulations.

(b) Commerce represents that it has complied in all respects with the requirements of law in its past business operations. The financial statements of Commerce, as of the date of this agreement, are attached hereto as Exhibit A. Commerce represents these financial statements are accurate and that it will not cause substantial change to occur before the effective date of merger. Citizens shall have the right to conduct such examination of the books and records of Commerce as it elects at any time prior to the effective date of merger.

(c) Commerce represents that it has no liabilities not disclosed in connection with this transaction.

13. *Non competition covenant.* All officers and directors of Commerce, for themselves and in their official capacities, hereby covenant that for a period of five years from the date of this merger, they will not act in any way directly or indirectly to compete with or act adversely to the Surviving Association in the Seattle/Tacoma/Everett area. Positions they already hold shall not be deemed to violate this provision.

In no way limiting the generality of said covenant, the prohibited acts include but are not limited to:

(a) Making use of or aiding in the attempted use by others, of names "Citizens" or "Commerce" for a financial institution in the Seattle/Tacoma/Everett area.

14. *Time limit in which to complete merger.* This agreement for merger shall terminate and the merger shall

not take place if the acts set forth in paragraph 1 above entitled "Merger" have not been completed by April 1, 1976. The time limit set forth herein may be extended by a joint act of the majorities of the Boards of Directors of Citizens and Commerce. The time limit shall be extended for a reasonable time for the purpose of complying with the provisions of paragraphs 1(c) thru 1(e) herein. Both parties expressly covenant and agree that they will take all reasonable and possible steps at the earliest opportunity to accomplish the performance called for herein, in the shortest possible time after the execution of this agreement. In the event either party does not take steps quickly and effectively as covenanted hereinabove, such party expressly authorizes the other party to take such steps on its behalf in order that performance of this agreement be properly accomplished according to its terms.

15. *Right of amendment.* The surviving association hereby reserves the right to amend, alter, change or repeal any provision contained in its charter, in the manner now or hereinafter prescribed by law as from time to time amended; and rights and powers of whatsoever nature conferred in such charter upon any member, director, officer or any other person are subject to this reservation.

IN WITNESS WHEREOF, Citizens Federal Savings & Loan Association of Seattle and Commerce Savings & Loan Association have caused this agreement to be signed in their corporate names by their respective presidents or vice-presidents and their respective secretaries under the seals of the corporation, and also by majorities of their

respective Boards of Directors, all as of the day and year first above written.

Citizens Federal Savings & Loan Association

By: /s/ David P. Thompson
President

CORPORATE SEAL

(Attest)

/s/ C. E. McAllister
Secretary

Commerce Savings & Loan Association

By: /s/ Harold Paulsen
President

CORPORATE SEAL

(Attest)

/s/ E. H. Brus
Secretary

EXHIBIT "A"
Page 1 of 4

Shares	Value @ $12/shr	Passbk. 6 mo. Restric'n @ 5.25%	1½ Certif. @ 6.50%	2½yr. Certif. @ 6.75%	4 yr. Certif. @ 7.50%
326	3,912	1,174	2,738		
133	1,596	479	1,117		
1,996	23,952	7,186	7,186	4,790	4,790
407	4,884	1,465	1,465	1,954	
525	6,300	1,890	1,890	1,260	1,260
634	7,608	2,282	2,282	1,522	1,522
10,354	124,248	37,274	37,274	24,850	24,850
69	828	828			
12	144	144			
15	180	180			
2,222	26,664	7,999	7,999	5,333	5,333
346	4,152	1,246	1,246	1,660	
326	3,912	1,174	1,174	1,564	
12	144	144			
48	576	576			
1,959	23,508	7,052	7,052	4,702	4,702
2,681	32,172	9,652	9,652	6,434	6,434
1,978	23,736	7,121	7,121	4,747	4,747
58	696	696			
18,178	218,136	65,491	65,441	43,627	43,627
576	6,912	2,074	2,074	1,382	1,382
266	3,192	958	2,234		
286	3,432	1,030	1,030	1,372	
358	4,296	1,289	1,289	1,718	
1,306	15,672	4,702	4,702	3,134	3,134
27	324	324			
27	324	324			
1,757	21,084	6,325	6,325	4,217	4,217
27	324	324			
155	1,860	558	1,302		
4	48	48			
155	1,860	558	1,302		
133	1,596	479	1,117		
118	1,416	1,416			
1,589	19,068	5,720	5,720	3,814	3,814
115	1,380	1,380			
79	948	948			
364	4,368	1,310	1,310	1,748	
7,383	88,596	26,579	26,579	17,719	17,719
2	24	24			
302	3,624	1,087	1,087	1,450	
634	7,608	2,282	2,282	1,522	1,522
667	8,004	2,401	2,401	1,601	1,601
2,631	31,572	9,472	9,472	6,314	6,314
606	7,272	2,182	2,182	1,454	1,454
60	720	720			
Total 61,906	$742,872	$228,517	$226,045	$149,588	$138,422

EXHIBIT "A"
Page 2 of 4

Shares	Value @ $12/shr	Passbk. 6 mo. Restric'n @ 5.25%	1½ Certif. @ 6.50%	2½yr. Certif. @ 6.75%	4 yr. Certif. @ 7.50%
667	8,004	2,401	2,401	1,601	1,601
654	7,848	2,354	2,354	1,570	1,570
11,272	135,264	40,579	40,579	27,053	27,053
412	4,944	1,483	1,483	1,978	
2	24	24			
1,337	16,044	4,813	4,813	3,209	3,209
155	1,860	558	1,302		
272	3,264	979	2,285		
57	684	684			
110	1,320	1,320			
358	4,296	1,289	1,289	1,718	
667	8,004	2,401	2,401	1,601	1,601
1,337	16,044	4,813	4,813	3,209	3,209
86	1,032	1,032			
57	684	684			
994	11,928	3,578	3,578	2,386	2,386
2,578	30,936	9,281	9,281	6,187	6,187
2	24	24			
2	24	24			
141	1,692	508	1,184		
133	1,596	479	1,117		
169	2,028	608	1,420		
1	12	12			
788	9,456	2,837	2,837	1,891	1,891
728	8,736	2,621	2,621	1,747	1,747
10,071	120,852	36,256	36,256	24,170	24,170
686	8,232	2,470	2,470	1,646	1,646
667	8,004	2,401	2,401	1,601	1,601
572	6,864	2,059	2,059	1,373	1,373
654	7,848	2,354	2,354	1,570	1,570
319	3,828	1,148	1,148	1,532	
12	144	144			
12	144	144			
390	4,680	1,404	1,404	1,872	
728	8,736	2,621	2,621	1,747	1,747
2	24	24			
10,144	121,728	36,518	36,518	24,346	24,346
1,119	13,428	4,028	4,028	2,686	2,686
1,119	13,428	4,028	4,028	2,686	2,686
1,119	13,428	4,028	4,028	2,686	2,686
1,565	18,780	5,634	5,634	3,756	3,756
667	8,004	2,401	2,401	1,601	1,601
671	8,052	2,416	2,416	1,610	1,610
332	3,984	1,195	1,195	1,594	
423	5,076	1,523	1,523	1,015	1,015
423	5,076	1,523	1,523	1,015	1,015
Total 54,674	$656,088	$199,705	$199,765	$132,656	$123.962

EXHIBIT "A"
Page 3 of 4

Shares	Value @ $12/shr	Passbk. 6 mo. Restric'n @ 5.25%	1½ Certif. @ 6.50%	2½yr. Certif. @ 6.75%	4 yr. Certif. @ 7.50%
654	7,848	2,354	2,354	1,570	1,570
266	3,192	958	2,234		
728	8,736	2,621	2,621	1,747	1,747
4,694	56,328	16,898	16,898	11,266	11,266
667	8,004	2,401	2,401	1,601	1,601
2,681	32,172	9,652	9,652	6,434	6,434
165	1,980	594	1,386		
185	2,220	666	1,554		
5	60	60			
55	660	660			
962	11,544	3,463	3,463	2,309	2,309
55	660	660			
17,459	209,508	62,852	62,852	41,902	41,902
70	840	840			
70	840	840			
57	684	684			
26	312	312			
667	8,004	2,401	2,401	1,601	1,601
1,097	13,164	3,949	3,949	2,633	2,633
10,137	121,644	36,493	36,493	24,329	24,329
609	7,308	2,192	2,192	1,462	1,462
728	8,736	2,621	2,621	1,747	1,747
286	3,432	1,030	1,030	1,372	
133	1,596	479	1,117		
155	1,860	558	1,302		
155	1,860	558	1,302		
155	1,860	558	1,302		
165	1,980	594	1,386		
2,005	24,060	7,218	7,218	4,812	4,812
1,912	22,944	6,883	6,883	4,589	4,589
108	1,296	1,296			
1,579	18,948	5,684	5,684	3,790	3,790
15	180	180			
60	720	720			
667	8,004	2,401	2,401	1,601	1,601
1,174	14,088	4,226	4,226	2,818	2,818
190	2,280	684	1,596		
1,277	15,324	4,597	4,597	3,065	3,065
141	1,692	508	1,184		
1,623	19,476	5,843	5,843	3,895	3,895
133	1,596	479	1,117		
110	1,320	1,320			
4	48	48			
4	48	48			
4	48	48			
3,832	45,984	13,795	13,795	9,197	9,197
Total 57,924	$695,088	$213,926	$215,054	$133,740	$132,368

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Shares	Value @ $12/shr	Passbk. 6 mo. Restric'n @ 5.25%	1½ Certif. @ 6.50%	2½yr. Certif. @ 6.75%	4 yr. Certif. @ 7.50%
66	$ 792	$ 792	$	$	$
243	2,916	875	2,041		
3,590	43,080	12,924	12,924	8,616	8,616
11,149	133,788	40,136	40,136	26,758	26,758
110	1,320	1,320			
2,025	24,300	7,290	7,290	4,860	4,860
312	3,744	1,123	1,123	1,498	
667	8,004	2,401	2,401	1,601	1,601
794	9,528	2,858	2,858	1,906	1,906
13,200	158,400	47,520	47,520	31,680	31,680
1,098	13,176	3,953	3,953	2,635	2,635
2,901	34,812	10,444	10,444	6,962	6,962
319	3,828	1,148	1,148	1,532	
155	1,860	558	1,302		
366,629	$439,548	$133,342	$133,140	$88,048	$85,018

- SUMMARY -

Total:						
page 1	61,906	742,872	228,517	226,045	149,888	138,422
page 2	54,674	656,088	199,705	199,765	132,656	123,962
page 3	57,924	695,088	213,926	215,054	133,740	132,368
page 4	36,629	439,548	133,342	133,140	88,048	85,018
	211,133	$2,533,596	$775,490	$774,004	$504,332	$479,770

No. 83-832

In the Supreme Court of the United States

OCTOBER TERM, 1984

HAROLD T. PAULSEN, ET UX., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether a taxpayer qualifies for nonrecognition of realized gain under Section 354(a)(1) of the Internal Revenue Code when, upon the merger of a stock savings and loan association into a mutual savings and loan association, he surrenders his stock in the former and receives a passbook savings account and short-term certificates of deposit in the latter.

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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 20-32) is reported at 716 F.2d 563. The opinion of the Tax Court (Pet. App. 1-18) is reported at 78 T.C. 291.

JURISDICTION

The judgment of the court of appeals (Pet. App. 33) was entered on August 16, 1983. The petition for a writ of certiorari was filed on November 14, 1983, and was granted on February 21, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES INVOLVED

The relevant portions of 12 U.S.C. 1464 and of Sections 116, 354, 356, 368, 581, 591, 593, 1002, and 7701(a)(19) of the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax year at issue, are set out in a statutory appendix (App., *infra*, 1a-11a).

STATEMENT

1. Petitioners were shareholders of Commerce Savings and Loan Association (Commerce), a state-chartered, stock institution that offered various classes of savings accounts to the public. On June 30, 1976, petitioners owned 17,459 shares of Commerce stock with a tax basis, or cost, of about $57,000. Petitioners' shares (called "guaranty stock") had all the features normally associated with common stock issued by a corporation. Pet. App. 2-3, 20-21; see J.A. 27-28.

Citizens Federal Savings and Loan Association (Citizens) is a federally-chartered, mutual institution that offers various classes of savings accounts to the public. As a mutual institution, Citizens has no capital stock. Each borrower is entitled to one vote, and each savings account holder is entitled to one vote for every $100 (or fraction thereof) on deposit (Pet. App. 3-4, 21). Regardless of the amount he has on deposit, no account holder is entitled to more than 400 votes (*id.* at 21). Citizens' articles and by-laws provide that its net earnings are to be distributed semi-annually to savings account holders on a pro rata basis (J.A. 43-44). In practice, however, it pays a fixed, preannounced rate on all accounts (Pet. App. 27). Citizens must honor requests for withdrawals from savings accounts within 30 days of the request (*id.* at 4). It may redeem all or any part of its accounts at a price equivalent to "the full value

thereof, as determined by the board of directors" (J.A. 42). In practice, however, the redemption price is the outstanding balance in the account (Pet. App. 21-22; J.A. 42). In the event of liquidation, dissolution, or winding up, all account holders are "entitled to equal distribution of assets pro rata to the value of their savings accounts" (Pet. App. 4-5, 21-22).

On July 1, 1976, Commerce was merged into Citizens. Under the merger plan, Commerce stockholders were to receive a $12 deposit in a Citizens passbook savings account for each share of Commerce stock they owned. Alternatively, they could surrender their stock for Citizens certificates of deposit (CDs) of various maturities.[1]

Pursuant to the merger, petitioners surrendered their 17,459 shares of Commerce stock for a Citizens passbook savings account and short-term CDs with an aggregate face amount and value of about $210,000.[2]

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[1] The CDs had maturities ranging from one to ten years (J.A. 17). Deposits in passbook savings accounts issued in the merger could not be withdrawn for one year (*ibid.*), but each former Commerce stockholder was given preferential borrowing privileges against those deposits (Pet. App. 5, 22).

[2] The exact breakdown of the consideration petitioners received (Pet. App. 6) was as follows:

Number of Shares	Date of Acquisition	Cost Basis	Consideration Received		Gain Realized
			Amount	Type	
3,356	3/8/63	$ 7,500	$ 40,272	Passbook	$ 32,772
3,359	6/26/70	7,500	40,308	2 yr. cert.	32,808
3,358	12/31/71	7,500	40,296	18 mos. cert.	32,796
3,358	10/24/72	7,500	40,296	18 mos. cert.	32,796
667	1/1/73	7,530	8,004	1 yr. cert.	474
1,971	2/19/74	6,000	23,652	3 yr. cert.	17,652
861	6/30/76	7,500	10,332	3 yr. cert.	2,832
529	6/30/76	5,772	6,348	4 yr. cert.	576
17,459		$56,802	$209,508		$152,706

They thus realized a gain of $153,000. Petitioners did not report this gain as income on their 1976 federal income tax return. Instead, they took the position that the transaction was a corporate "reorganization" and that the realized gain, accordingly, should not be currently recognized. Section 368(a)(1)(A) of the Code[3] defines "reorganization" to include "a statutory merger." Section 354(a)(1) generally provides that, in the case of two corporations participating in a reorganization, "[n]o gain or loss shall be recognized" to a shareholder whose stock in one is, pursuant to the plan of reorganization, exchanged solely for stock in the other. Petitioners contended that the Citizens savings accounts they received in the merger were "stock," since Citizens was a mutual institution, and since those accounts theoretically represented ownership interests in it.

2. On audit, the Commissioner determined that the merger was not a tax-free reorganization, and that petitioners were required to recognize their $153,000 gain immediately (Pet. App. 6; J.A. 8-13).[4] His determination was premised on the well-established principle that a transaction qualifies as an exchange pursuant to a "reorganization" only if it is not, in substance, a sale. In order to constitute a reorganization exchange rather than a sale, the transaction must evince a "continuity of proprietary interest." *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933); *LeTulle* v. *Scofield*, 308 U.S. 415 (1940). The ownership interest that the old corporation's shareholders acquire in the new corporation, moreover, must be "definite and material" and must "represent a substantial part of the value of the thing transferred." *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

The Commissioner determined that petitioners acquired no meaningful ownership interest in Citizens when they received the CDs and passbook savings account. He viewed those dollar obligations as constituting, not "stock," but a "hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" (Pet. App. 10). The Commissioner concluded that the accounts' equity features had minimal value, that their value did not "represent a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of the Commerce stock petitioners gave up, that petitioners in essence had become creditors of Citizens, and that the transaction was thus a sale. Alternatively, the Commissioner contended (J.A. 11-13) that, even if petitioners' ownership interest was sufficient to enable the transaction to qualify as a "reorganization," the dollar obligations they received in exchange for their stock represented, not "stock," but some combination of "securities," "money," and "other property," and that petitioners' gain had to be recognized up to the value of those non-equity interests. See I.R.C. §§ 354(a)(2), 356(a)(1) and (d).

3. Petitioners sought redetermiation of the resulting deficiency in the Tax Court. Following *Capital Savings & Loan Ass'n* v. *United States*, 607 F.2d 970

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[3] Unless otherwise noted, all statutory references are to the Internal Revenue Code of 1954 (26 U.S.C.), as in effect for the tax year at issue (the Code or I.R.C.).

[4] The Commissioner proposed to accord long-term capital gain treatment to $149,000 of petitioners' gain. He proposed to accord short-term treatment to the balance, on the ground that petitioners, in surrendering their stock, had engaged in an early disposition of 1,390 shares that they had acquired pursuant to stock options on the eve of the merger. See I.R.C. §§ 421, 422; J.A. 11-12, 15.

(Ct. Cl. 1979), *West Side Federal Savings & Loan Ass'n* v. *United States*, 494 F.2d 404 (6th Cir. 1974), and *Everett* v. *United States*, 448 F.2d 357 (10th Cir. 1971), the Tax Court held that the passbook savings account and CDs received by petitioners satisfied the "continuity of proprietary interest" test and that the transaction was, accordingly, a tax-free reorganization (Pet. App. 10-17). The Tax Court also rejected the Commissioner's alternative contention, concluding that "the cash deposit and proprietary rights represented by [the savings] accounts [were] not separable," that their proprietary rights rendered them "stock," and that the accounts thus necessarily could not be "securities," "money," or "other property" as the Commissioner urged (*id.* at 17-18 n.25). The court acknowledged that the Commissioner was "not without arguments" and that "treating savings accounts as 'stock' * * * raises a number of logical and practical administrative problems" (*id.* at 15-16 & n.22). But while the court suggested that it would have "give[n] greater weight to those problems in reaching [its] decision" if the question were one of first impression, it "fe[lt] constrained to follow the guidance" of the three appellate decisions cited above (*id.* at 16).

The court of appeals unanimously reversed (Pet. App. 20-32), following its earlier decision in *Home Savings & Loan Ass'n* v. *United States*, 514 F.2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975). The court acknowledged that the CDs and passbook savings accounts carried with them certain proprietary features, but concluded that their debt features "overwhelmingly predominate[d]" (Pet. App. 24), that they were "in reality indistinguishable from ordinary savings accounts" (*id.* at 30-31), and that they were "essentially the equivalent of cash" (*id.* at

31). Because the accounts, "though * * * ownership interests for some purposes, [did] not 'partake sufficiently of equity characteristics' to qualify [the] transaction as a tax free reorganization" (Pet. App. 32), the court held that petitioners in essence had sold their stock and were thus required to recognize their gain at once.

SUMMARY OF ARGUMENT

The Internal Revenue Code generally provides that "on the sale or exchange of property the entire amount of the gain or loss * * * shall be recognized" (26 U.S.C. (1970 ed.) 1002). Sections 354 to 368 set forth exceptions to this rule in the case of certain "exchanges" incident to a corporate "reorganization." These provisions allow parties exchanging property in a merger or similar transaction to avoid current recognition of gain or loss, *provided* that the transaction represents "only a readjustment of continuing interest[s] in property under modified corporate forms" (Treas. Reg. § 1.368-1(b)). The "reorganization" provisions presuppose that the investor's new property "is substantially a continuation of [his] old investment still unliquidated" (Treas. Reg. § 1.1002-1(c)). If the investor liquidates or "cashes out" his equity stake, the transaction is not a "reorganization exchange" but a "sale," and gain or loss must be recognized at once.

Once a "reorganization exchange," rather than a "sale," is found, the Code sets strict limits on the kinds of consideration that can be received tax-free. Section 354(a)(1), as relevant here, provides that a shareholder will recognize no gain or loss if he exchanges stock in one corporation which is a party to the reorganization solely for stock in another corpora-

tion which is a party to the reorganization. If, however, a shareholder surrenders only stock, and gets back, not just "stock," but also "securities" (generally, debt obligations), "money" or "other property," he must recognize his gain (if any) up to the value of those non-equity interests (I.R.C. §§ 354(a)(2), 356(a)(1), (d)(1) and (2)). These rules implement the basic principle of "reorganization" tax law, namely, that gain or loss must be recognized to the extent a taxpayer liquidates, rather than continues, his equity stake.

Here, petitioners surrendered their stock in Commerce for dollar obligations in Citizens. That transfer was not a tax-free "reorganization exchange," for two distinct reasons. First, while formally structured as a merger, the transaction was in reality a purchase of assets by Citizens and a sale of their Commerce stock by petitioners. Second, even if the transaction was a "reorganization," the consideration petitioners received was not "stock," but some combination of "securities," "money" and "other property," accompanied by a nominal equity participation. To the extent of the value of the non-equity interests petitioners received, therefore, they must recognize their gain in any event.

1. This Court has consistently held that a transfer of corporate assets for cash or dollar obligations is not a "reorganization exchange" but a sale. In order for a merger to qualify as a "reorganization," the transferor's shareholders must acquire in the transferee company an equity interest that is "definite and material" and that "represent[s] a substantial part of the value" of the total consideration they receive (*Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378, 385 (1935).

The equity stake petitioners acquired in Citizens did not "represent a substantial part of the value" of what they got in the merger. What they got, after all, were savings accounts in a federally-insured institution. Over a period of years since 1951, Congress has increasingly assimilated mutual S&Ls and their account holders to banks and their depositors. For federal tax purposes, those accounts since long before 1976 have been treated exactly like bank deposits, and the so-called "dividends" Citizens pays on those accounts have been treated exactly like interest paid by a bank.

It is true that petitioners' savings accounts were accompanied by certain proprietary features, viz., a limited right to vote and a contingent right to participate in the proceeds of a solvent liquidation. But those rights had no substantial value. In practice, depositors rarely exercise their voting rights and attach no importance to them. And this Court has noted that the solvent liquidation of a savings institution is "such a remote contingency" that any theoretical value of the right to participate in a liquidation "reduces almost to the vanishing point" (*Society for Savings* v. *Bowers*, 349 U.S. 143, 150 (1955)). Obviously, no one would pay anything, beyond the number of dollars on deposit, for the "equity features" accompanying petitioners' savings accounts, for one could acquire those equity features for free simply by using the same number of dollars to open an account in one's own name.

The value of the consideration petitioners received, in short, was almost wholly represented by the savings accounts' "debt features," viz., the right to withdraw $210,000 in cash on demand or at stated intervals. Since the accounts' equity features thus did

not "represent a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of the total consideration petitioners received, the court of appeals correctly held that the merger effected, not a "reorganization exchange," but a sale.

2. Even if petitioners' savings accounts were sufficiently imbued with equity characteristics to enable the overall transaction to qualify as a "reorganization," the effects of that reorganization *upon petitioners* would still have to be gauged by testing the consideration they received under Sections 354 and 356. Since petitioners surrendered only stock, they must recognize gain to the extent that they received, not just "stock," but "securities," "money" or "other property" (I.R.C. §§ 354(a)(2), 356(a)(1), (d)(1) and (2)).

Petitioners' savings accounts plainly do not constitute "stock" pure and simple. Rather, the accounts represent "hybrid interest[s]" (Pet. App. 10), short-term debt obligations accompanied by nominal equity features. There is no need in this case to decide whether the non-equity features of the savings accounts should be considered "securities," "money" or "other property." Since petitioners surrendered only "stock," they must recognize gain to the extent they got back anything but "stock," regardless of how those non-equity interests are denominated.

Here, as noted above, the nonstock rights that petitioners received consisted of the right to withdraw $210,000 in cash from Citizens. The fair market value of that right is stipulated to be $210,000. Since the value of the non-equity interests petitioners acquired thus exceeds the gain they realized ($153,000), they must recognize that gain in full. This result, of course, is the same as the result produced by our

primary submission—that the transaction was a sale and not a "reorganization exchange"—but that merely confirms that our primary submission is correct.

ARGUMENT

THE COURT OF APPEALS CORRECTLY HELD THAT THE GAIN PETITIONERS REALIZED WAS TO BE CURRENTLY RECOGNIZED IN THEIR 1976 TAXABLE YEAR

Section 1002 of the Code, effective during 1976,[5] stated that, "[e]xcept as otherwise provided in [subtitle A of the Code], on the sale or exchange of property the entire amount of the gain or loss * * * shall be recognized." Among the Code sections that "otherwise provide" are Sections 354 to 368, governing certain transactions in connection with "corporate reorganizations." Section 354(a)(1) says that "[n]o gain or loss shall be recognized" if stock or securities in a corporation which is a party to a reorganization are "exchanged solely for stock or securities * * * in another corporation [which is] a party to the reorganization." To qualify for nonrecognition of gain or loss, a transaction whereby a shareholder surrenders stock in one of the corporations must constitute, not a "sale," but an "exchange" that establishes a continuity of his proprietary interest in the other company. Treas. Reg. § 1.368-1(b).

Once a "reorganization exchange" is found, Sections 354(a)(2) and 356 limit the kinds of consid-

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[5] Effective for taxable years beginning after December 31, 1976, Congress repealed Section 1002 and reenacted its provisions (with slight verbal changes) as Section 1001(c). Tax Reform Act of 1976, Pub. L. No. 94-455, § 1901(a)(121) and (b)(28)(B)(i), 90 Stat. 1784, 1799.

eration that can be received tax-free. Section 356(a)(1) provides that, if a taxpayer receives, besides "stock or securities," "other property or money," he must recognize gain (if any) up to "the sum of such money and the fair market value of such other property." Section 354(a)(2)(B), moreover, imposes additional restrictions where securities (generally, debt obligations) are received "and no such securities are surrendered.". In such situations, the securities received constitute "other property" (I.R.C. § 356(d)(1) and (2)), and gain must be recognized up to the fair market value thereof (I.R.C. §§ 354(a)(2)(B), 356(d)(2)(B)). See generally B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.31, at 14-97 (4th ed. 1979) (hereinafter cited as Bittker & Eustice) (citing cases). In short, if a shareholder participating in a "reorganization exchange" surrenders only stock, and gets back anything besides "stock," he must recognize gain (if any) up to the value of those non-equity interests.

The underlying assumption of the reorganization provisions, as of all the Code's tax-free exchange provisions, "is that the new property is substantially a continuation of the old investment still unliquidated." Treas. Reg. § 1.1002-1(c). The reorganization provisions were enacted "to free from the imposition of an income tax purely paper profits or losses wherein there is no realization of gain or loss in the business sense but merely recasting of the same interests in a different form." *Southwest Natural Gas Co.* v. *Commissioner*, 189 F.2d 332, 334 (5th Cir.), cert. denied, 342 U.S. 860 (1951) (quoting *Commissioner* v. *Gilmore's Estate*, 130 F.2d 791, 794 (3d Cir. 1942) (original quotation marks omitted)). The principle that a reorganization entails "only a readjustment of

continuing interest[s] in property under modified corporate forms" (Treas. Reg. § 1.368-1(b)) lies "at the heart of the nonrecognition provisions and is the reason why gain or loss, although realized, is not recognized at the time of the exchange." Bittker & Eustice ¶ 14.01, at 14-4. The converse of this principle, of course, is that a shareholder who liquidates or "cashes out" his equity investment, whether in whole or in part, must recognize gain at once.

Petitioners contend that their surrender of Commerce stock for Citizens' savings accounts was a tax-free reorganization exchange within the intendment of these provisions. It was not, for two distinct reasons. First, the transaction, while formally structured as a merger, was in reality a sale. Second, even if the merger was a "reorganization," the dollar obligations petitioners received were not "stock," and, since they surrendered only stock, those obligations could not be received tax-free.

A. The transaction in which petitioners surrendered stock in Commerce and received a passbook savings account and certificates of deposit in Citizens was not a reorganization, but a sale

This Court and others early found it necessary to differentiate between "sales" on the one hand and "reorganization exchanges" that will qualify to produce nonrecognition of gain on the other. The problem emerged in *Cortland Specialty Co.* v. *Commissioner*, 60 F.2d 937 (2d Cir. 1932), in which a corporation had transferred its assets to another corporation for cash and short-term promissory notes. The court, speaking through Judge Augustus Hand, held the transaction "a mere sale" (60 F.2d at 937, 940), notwithstanding its literal compliance with the

Code's then-existing definition of a reorganization.[6] A "reorganization," the court reasoned, "presuppose[s] a continuance of interest on the part of the transferor in the properties transferred" (*id.* at 940). The court accordingly held that "[a] sale of the assets of one corporation to another for cash * * * is quite outside the objects of merger and consolidation statutes" (*id.* at 939).

This Court soon faced the same problem in *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933). That case likewise involved an intercorporate transfer of assets for cash and short-term notes. Specifically approving Judge Hand's opinion in *Cortland Specialty*, this Court held that the facts "failed to show a 'reorganization' within the statutory definition" (287 U.S. at 469). "[T]he mere purchase for money of the assets of one Company by another," the Court reasoned, was "beyond the evident purpose of the [reorganization] provision, and ha[d] no real semblance to a merger" (287 U.S. at 469, 470). "[T]o be within the exemption," rather, "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes" (*id.* at 470).

In *LeTulle* v. *Scofield*, 308 U.S. 415 (1940), the consideration received by the transferor comprised

[6] A "reorganization" was then defined broadly to include "a merger or consolidation (including the acquisition by one corporation of * * * substantially all the properties of another corporation)." Revenue Act of 1926, ch. 27, § 203(h)(1), 44 Stat. 14. Section 203(b)(3) of the 1926 Revenue Act, 44 Stat. 12, the predecessor of Section 361 of the 1954 Code, provided for nonrecognition of gain to a corporate party to a reorganization upon the exchange of property solely for stock or securities in another corporate party to the reorganization.

cash and long-term bonds. The Court recited its earlier holdings that, "where the consideration consists of cash and short term notes, the transfer * * * is a sale upon which gain or loss must be reckoned," and went on to hold that "the term of the obligations [was] not material" (308 U.S. at 420). "Where the consideration is wholly in the transferee's bonds, or part cash and part such bonds, we think it cannot be said that the transferor retains any proprietary interest in the enterprise. On the contrary, he becomes a creditor of the transferee" (*id.* at 420-421).[7]

These cases established that a transaction is a "sale" and not a "reorganization exchange" where the sole consideration received comprises debt obligations and cash. In *Helvering* v. *Minnesota Tea Co.*, 296 U.S. 378 (1935), this Court considered the proper outcome where the transferor receives some equity as well. The Court noted its holding in *Pinellas Ice* that

[7] The Treasury Regulations, drawing upon these cases, early formulated the difference between a sale and a reorganization in terms of the requirement of "continuity of proprietary interest." See Treas. Reg. 86, art. 112(g)(2) (1935) ("The term ['reorganization'] does not embrace the mere purchase by one corporation of the properties of another corporation, for it imports a continuity of interest on the part of the transferor or its stockholders in the properties transferred. If the properties are transferred for cash and deferred payment obligations of the transferee evidenced by short term notes, the transaction is a sale and not an exchange."). This provision has been repeated, and expanded upon, in all succeeding regulations. *E.g.*, Treas. Reg. §§ 1.368-1(b), 1.368-2(a). The courts have uniformly held that these principles apply to intercorporate asset transfers, regardless of whether they are formally structured as a purchase of assets or (as here) as a statutory merger. See *Southwest Natural Gas Co.*, 189 F.2d at 334; *Roebling* v. *Commissioner*, 143 F.2d 810, 812 (3d Cir.), cert. denied, 323 U.S. 773 (1944).

a reorganization presupposes on the transferor's part a continuing " 'interest in the affairs of the purchasing company' " (296 U.S. at 385 (quoting 287 U.S. at 470)). "[W]e now add," the Court wrote, "that this interest must be definite and material" and "must represent a substantial part of the value of the thing transferred" (296 U.S. at 385). In the Court's view, it did not matter that "the relationship of the [transferor] to the assets conveyed was substantially changed," since this will invariably occur in a reorganization. The important point, rather, was to compare the value of the equity interest received to the value of the total consideration received, so as to determine whether the former "represent[ed] a substantial part of the value" of the latter (296 U.S. at 385, 386).[8]

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[8] The relative amounts of equity and non-equity consideration that can be received by the transferor consistently with the "continuity of proprietary interest" requirement have never been precisely defined. In *Minnesota Tea*, consideration comprising 56% common stock and 44% cash was held to suffice (296 U.S. at 381-382, 385). In *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374 (1935), consideration comprising 38% equity (consisting of an entire issue of preferred stock) and 62% cash was likewise held satisfactory. See 296 U.S. at 376; Bittker & Eustice ¶ 14.11, at 14-19. Transactions in which equity represents less than 20% of the total consideration have almost invariably been considered sales. See, *e.g.*, *Southwest Natural Gas*, 189 F.2d at 334-335 (1% equity); *Yoc Heating Corp.* v. *Commissioner*, 61 T.C. 168, 177-178 (1973) (15% equity); *Kass* v. *Commissioner*, 60 T.C. 218, 227 (1973) (16% equity); Rev. Rul. 80-285, 1980-2 C.B. 119 (19% equity); Rev. Rul. 80-284, 1980-2 C.B. 117 (14% equity). For advance ruling purposes, the IRS regards 50% equity as sufficient for "continuity of interest" purposes. Rev. Proc. 77-37, 1977-2 C.B. 568, 569; Rev. Rul. 66-224, 1966-2 C.B. 114-115.

In the present case, petitioners surrendered their Commerce stock for Citizens dollar obligations—a passbook savings account and time certificates of deposit—that were functionally equivalent to short-term promissory notes. There can be no doubt under the cases discussed above that, if petitioners had transferred their a stock for identical consideration to an ordinary corporation, a commercial bank, or a stock savings and loan association, the transfer would be a sale and their gain would be immediately recognized. The only question is whether the result should be different here simply because the buyer was a mutual institution.

We submit that any such difference in result would be unjustifiable. Petitioners acknowledge that their savings accounts "in some ways resemble bank deposits" (Br. 6), yet assert that the resemblance is merely superficial and that, by becoming "members" in Citizens, they gained proprietary rights significantly different from the rights of a bank depositor. Their claim does not withstand analysis. The provisions of the Internal Revenue Code governing mutual savings and loan associations demonstrate that those institutions, for federal tax purposes, are substantially identical to banks, and that accounts maintained at those institutions, for federal tax purposes, are substantially identical to bank deposits. And when the merger is considered in pragmatic rather than in formal terms, it is clear that the equity features accompanying petitioners' accounts—which are the same equity features accompanying all of Citizens' savings accounts—did not "represent a substantial part of [their] value" (*Minnesota Tea*, 296 U.S. at 385), and that the merger, from both Citizens' and petitioners' points of view, was a sale.

1. In construing other statutes, this Court has held that withdrawable accounts in a savings and loan association, for purposes for the Securities Exchange Act of 1934, 15 U.S.C. 78a, constitute "securities" (*Tcherepnin* v. *Knight*, 389 U.S. 332 (1967)), and that such accounts, for purposes of 38 U.S.C. 3101(a) (relating to the exempt status of veterans benefits) "retain the qualities of moneys [which] have not been converted into permanent investments" (*Porter* v. *Aetna Casualty Co.*, 370 U.S. 159, 162 (1962)). Both decisions, of course, turned upon the language and purposes of the particular statutes under which the cases arose, and neither purported to establish a universal rule. But they do demonstrate that it is appropriate in this tax case to look first to the manner in which the Internal Revenue Code deals with savings and loan associations, particularly federally-chartered, mutual associations like Citizens. The evolution of the relevant Code provisions reveals a deliberate congressional intent increasingly to assimilate those institutions and their members to banks and their depositors.

Until 1951, most mutual savings banks, cooperative banks, domestic building and loan associations, and federal savings and loan associations were exempt from the federal income tax.[9] In 1951, however, Congress found that these institutions were in active

[9] The exemption for federal S&Ls was accomplished by the Home Owners Loan Act of 1933, ch. 64, § 5(h), 48 Stat. 133, 12 U.S.C. (1946 ed.) 1464(h). The exemption for the other three groups was accomplished by Section 101(2) and (4) of the Internal Revenue Code of 1939, ch. 2, 53 Stat. 33 (hereinafter 1939 Code).

competition with other financial institutions[10] and were no longer principally engaged in fulfilling the "mutual" functions for which they had been established.[11] The Senate Finance Committee noted that

[10] See, *e.g.*, S. Rep. 781 (Pt. 1), 82d Cong., 1st Sess. 25 (1951):

> At the present time, mutual savings banks are in active competition with commercial banks and life insurance companies for the public savings, and they compete with many types of taxable institutions in the security and real estate markets. As a result your committee believes that the continuance of the tax-free treatment now accorded mutual savings banks would be discriminatory. * * * The tax treatment provided by your committee would place mutual savings banks on a parity with their competitors.

[11] See, *e.g.*, S. Rep. 781, *supra*, at 27 (discussing state and federal S&Ls):

> In the early days of these institutions, the transactions of the associations were confined to members, and no one could participate in the benefits they afforded without becoming a shareholder. Individuals became investing members of these organizations in the expectation of ultimately becoming borrowing members as well. Membership implied not only regular payments to the association for a considerable period of time, but also risk of losses. Members could not cancel their memberships or withdraw their shares before maturity without incurring heavy penalties. The fact that the members were both the borrowers and the lenders was the essence of the "mutuality" of these organizations.
>
> Although many of the old forms have been preserved to the present day, few of the associations have retained the substance of their earlier mutuality. The steady decline in the proportion of share-accumulation loans is evidence that the character of these organizations has changed. More and more, investing members are becoming simply depositors, while borrowing members find dealing with a savings and loan association only tech-

"savings and loan associations are no longer self-contained cooperative institutions as they were when originally organized" and that "there is relatively little difference between their operations and those of other financial institutions which accept deposits and make real-estate loans." S. Rep. 781, 82d Cong., 1st Sess. 28 (1951). Accord, H.R. Conf. Rep. 1179, 82d Cong., 1st Sess. 71-73 (1951); H.R. Conf. Rep. 1213, 82d Cong., 1st Sess. 73-74 (1951).

Congress determined that maintenance of the existing tax exemption for mutual institutions under these circumstances would be "discriminatory" (S. Rep. 781, *supra*, at 25) and accordingly repealed it.[12] Consistently with that treatment, Congress amended the Code to allow mutual institutions a deduction for amounts placed in bad-debt reserves (similar to the deduction already granted banks), and to allow mutual institutions a deduction for amounts paid as "dividends" to their depositors (just as banks were permitted to deduct interest paid to theirs).[13] Con-

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nically different from dealing with other mortgage lending institutions in which the lending group is distinct from the borrowing group. In fact, borrowers ordinarily have very little voice in the affairs of most savings and loan associations.

One characteristic of the earlier mutuality which remains is the absence of capital stock. However, the character of the organization has been modified by the practice of paying more or less fixed rates of return on shares, and of building up substantial surplus accounts to protect shareholders against the risk of losses.

[12] Revenue Act of 1951, ch. 521, § 313(a), (b) and (c), 65 Stat. 490.

[13] Revenue Act of 1951, ch. 521, § 313(f), 65 Stat. 491, amending 1939 Code § 23(r), 53 Stat. 16. See S. Rep. 781, *supra*, at 28. The provision permitting mutual savings and loan associations to deduct "dividends" paid on deposits is now incorporated in I.R.C. § 591.

gress likewise revised the definitional provisions of the 1939 Code to include most savings and loan associations, whether state- or federally-chartered, within the definition of "banks."[14]

Three years later, in the Internal Revenue Code of 1954, Congress for the first time provided an exclusion from gross income for up to $50 of "dividends from domestic corporations." Internal Revenue Code of 1954, ch. 736, § 116(a), 68A Stat. 37. Congress was careful to provide, however, that this exclusion was not available for "dividends" paid by S&Ls to their depositors and deducted by the former under Section 591. *Id.* § 116(c)(1). Congress provided, rather, that such dividends "shall not be treated as a dividend" for this purpose (*ibid.*).[15]

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[14] Revenue Act of 1951, ch. 521, § 313(h), 65 Stat. 491, amending 1939 Code § 104(a), 53 Stat. 36 (revising definition of "bank" to include "a domestic building and loan association"); Revenue Act of 1951, ch. 521, § 313(i), 65 Stat. 491, adding 1939 Code § 3797(a)(19) (defining "domestic building and loan association" to include "a domestic savings and loan association" and "a Federal savings and loan association, substantially all the business of which is confined to making loans to members").

[15] In 1980, Congress temporarily amended Section 116 to provide an exclusion for up to $200 ($400 in the case of joint returns) of amounts received *either* as interest *or* as dividends from domestic corporations. Crude Oil Windfall Profit Tax Act of 1980, Pub. L. No. 96-223, § 404(a), 94 Stat. 305, amending I.R.C. § 116(a) and (b). "Interest" for that purpose was defined to include "interest on deposits with a bank" and "amounts (whether or not designated as interest) paid in respect of deposits • • • by a mutual savings bank, cooperative bank, [or] domestic building and loan association." *Id.* § 404(a), amending I.R.C. § 116(c)(1)(A) and (B).

In 1962, Congress expanded Section 591 to allow savings and loan associations to deduct, not only amounts paid "as dividends * * * on their deposits or withdrawable accounts," but also amounts paid "as dividends *or interest*" on those accounts.[16] Congress likewise drew a sharp line between "dividends" paid by S&Ls to their depositors (which were deductible under Section 591) and "distributions of property" paid by stock S&Ls to their shareholders (which were not to be deductible under Section 591).[17] Such "distributions of property," rather, were made subject to the provisions of the Code dealing with ordinary corporate dividends (I.R.C. §§ 301, 312, 317(a)), redemptions (I.R.C. § 302), and liquidations (I.R.C.

[16] Revenue Act of 1962, Pub. L. No. 87-834, § 6(f), 76 Stat. 984 (emphasis added), amending I.R.C. § 591. Congress in the same provision made the Section 591 deduction available to "other savings institutions chartered and supervised as savings and loan or similar associaitons under Federal or State law," even if they did not come within the definition of "domestic building and loan associations" set forth in Section 7701(a)(19). See S. Rep. 1881, 87th Cong., 2d Sess. 191 (1962); H.R. Conf. Rep. 2508, 87th Cong., 2d Sess. 24 (1962). At the same time, Congress amended and expanded the Section 7701(a)(19) definition to include almost all federal S&Ls, regardless of whether "substantially all [their] business * * * [was] confined to making loans to members." Compare Revenue Act of 1962, § 6(c), 76 Stat. 982-983, with 26 U.S.C. (1958 ed.) 7701(a)(19). This expansion reflected Congress's belief that S&Ls, in practice, were operating in the same fashion as other lending and financial institutions, *e.g.*, by making loans that were not in substance loans to members, but which were brought into conformance by making instantaneous "members" of borrowers. See H.R. Rep. 1447, 87th Cong., 2d Sess. 37, A49-A50 (1962); H.R. Conf. Rep. 2508, *supra*, at 21-23.

[17] Revenue Act of 1962, § 6(a), 76 Stat. 977-982, adding 26 U.S.C. (1964 ed.) 593(f) (currently codified as I.R.C. § 593(e)).

§§ 331, 346), provisions that, despite petitioners' suggestion to the contrary (Br. 41), are clearly inapplicable to withdrawals from savings accounts. See H.R. Rep. 1447, 87th Cong., 2d Sess. 36, A48 (1962); S. Rep. 1881, 87th Cong., 2d Sess. 47, 187-188 (1962). These amendments demonstrate a clear congressional intent that mutual savings accounts should not be treated as "stock" for federal tax purposes, since the "dividends" paid on those accounts are not subject to any of the rules applicable to dividends paid on stock generally.

Throughout this period, the capital structure of federal savings and loan associations was governed by Section 5(b) of the Home Owners' Loan Act of 1933, ch. 64, 48 Stat. 132, which provided that "[s]uch associations shall raise their capital only in the form of payments on * * * shares" and that "[n]o deposits shall be accepted" by them. In 1958, a group of commercial banks challenged the validity of Bank Board regulations issued under Section 5(b), contending that the regulations improperly authorized S&Ls to raise capital by accepting deposits and thus illegally to compete with banks. *Wisconsin Bankers Ass'n* v. *Robertson*, 294 F.2d 714 (D.C. Cir.), cert. denied, 368 U.S. 938 (1961). The court of appeals upheld the regulations, even though they defined S&L capital to include "payments on savings accounts" rather than "payments on shares" (294 F.2d at 716), and even though savings and loan associations were "coming to be regarded by the public much as the equivalent of a bank" (*id.* at 717 (Burger, J., concurring)).[18]

[18] Petitioners err (Br. 26-27) in relying on the concurring opinion of Judge (now Chief Justice) Burger in *Wisconsin Bankers* to support their position here. Judge Burger noted

In 1968, however, Congress decided that the formal capital structure of federal S&Ls should be brought more nearly into conformity with the public view of those institutions. It accordingly amended Section 5(b) to permit them to raise capital, not only in the form of "payments on shares," but in the form of "savings deposits, shares, or other accounts, for fixed, minimum, or indefinite periods of time * * * [or by issuing] such passbooks, time certificates of deposit, or other evidence of savings accounts as are * * * authorized." [19] The following year, Congress amended

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(294 F.2d at 717) that, even though "[t]he superficial similarities of [S&L] associations to banks [are] admittedly very great," the validity of the Board's regulations turned not on "appearances but [on] legal realities." Under the version of Section 5(b) then in effect, he observed, a savings and loan association was required to raise capital "by payments on shares" (294 F.2d at 717), and he found no reason to conclude that the Board's regulations, in speaking of "payment on savings accounts," intended improperly to expand their statutory powers. As noted in the text (pages 24-25), however, Congress has since amended Section 5(b) to permit S&Ls to raise capital by issuing all manner of depositary instruments, so that the "legal realities" as well as the economic appearances now confirm their bank-like nature. In any event, Judge Burger carefully tied his analysis to Section 5(b) of the Home Owners Loan Act. The question here concerns the proper construction of the Internal Revenue Code, and it is well established that the "substance" rather than the "form" of transactions governs for federal tax purposes. *Gregory* v. *Helvering*, 293 U.S. 465 (1935).

[19] Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 1716(a), 82 Stat. 608, amending 12 U.S.C. 1464(b). See H.R. Rep. 1585, 90th Cong., 2d Sess. 152 (1968); H.R. Conf. Rep. 1785, 90th Cong., 2d Sess. 164 (1968). In Section 1716(b) of the same law (82 Stat. 608) Congress amended Section 5(c) of the 1933 Act, 12 U.S.C. 1464(c), to provide that S&Ls should make loans "on the

the definition of "domestic building and loan association" in Section 7701(a)(19) of the Internal Revenue Code to conform it to the broadened provisions of Section 5(b) of the 1933 Act.[20] As amended, Section 7701(a)(19)(B) defined such associations to include those whose business "consists principally of acquiring the savings of the public and investing in loans"—a definition that aptly describes banks as well.

Petitioners lay great emphasis on the notion that their savings accounts are technically called "share accounts" (Br. 2, 3, 5) and that Citizens' charter permits it to raise capital only by accepting payments on accounts which "represent share interests in the association" (Br. 2, 18). The statutory developments outlined above, however, demonstrate that this terminology, for federal tax purposes at least, is a formalistic anachronism. Mutual savings and loan associations perform an economic function substantially similar to that performed by banks, and they are governed by a federal tax regime substantially similar to that governing banks. Their savings accounts, while retaining a name that sounds like equity, are for all practical purposes equivalent to debt, and are treated by the Internal Revenue Code

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security of [their] savings accounts" rather than "on the security of their shares." More recently, Congress has authorized federal S&Ls to accept demand deposits which have the same priority on liquidation as savings accounts, and to issue accounts that are subject to check or negotiable order of withdrawal. Thrift Institutions Restructuring Act of 1982, Pub. L. No. 97-320, § 301, 96 Stat. 1469, amending 12 U.S.C. 1464(b)(1)(A), (B) and (E).

[20] Tax Reform Act of 1969, Pub. L. No. 91-172, § 432(c), 83 Stat. 622.

as bank deposits and not as stock. The court of appeals thus correctly concluded (Pet. App. 30-31) that petitioners' savings accounts, "despite certain formal equity characteristics, are in reality indistinguishable from ordinary savings accounts and are essentially the equivalent of cash." [21]

2. The conclusion that petitioners' accounts were essentially bank deposits, dictated by the statutory developments outlined above, is confirmed when one considers the economic realities of the merger involved here. That transaction was plainly regarded by Citizens as a "purchase" and by petitioners as a "sale." For tax purposes it should be treated the same way.

a. By virtue of the merger, Citizens acquired another savings and loan association—its bricks and

[21] As petitioners note with some frequency (Br. 5, 11, 28, 29, 35), the definitional provisions of the Code generally provide that "[t]he term 'stock' includes shares in an association" and that "[t]he term 'shareholder' includes a member in an association." I.R.C. § 7701(a)(7) and (8). Those general definitions, however, apply only where not "manifestly incompatible with the intent" of other, more particular, Code provisions. I.R.C. § 7701(a) (first sentence). To treat S&L share accounts as "stock" would be "manifestly incompatible" with Section 593(e), which draws a sharp line between the "dividends" paid on such accounts and true corporate dividends. See pages 22-23, *supra*. And to treat S&L share accounts as "stock" would be "manifestly incompatible with the intent" of the Code's reorganization provisions, which presuppose a continuity of proprietary interest. Far more relevant to decision here is the definition of "domestic building and loan association" contained in Section 7701(a)(19), which, as noted above (pages 21 & note 14, 22 & note 16, 24-25, *supra*), represents the culmination of a process by which savings and loan associations for tax purposes were gradually assimilated to banks.

mortar, its typewriters and automatic tellers, and, most importantly perhaps, its customer base. Citizens paid for its acquisition with various types of short-term debt. Those instruments, because subject to withdrawal on demand or at stated maturities, are obviously "liabilities" in an economic and balance-sheet sense. It is true that Citizens, like many buyers, elected to finance its purchase by making its dollar obligations due serially over time. But a purchase thus financed is a purchase just the same.

For analytical purposes, it is revealing to note the tax consequences of "reorganization" treatment for an *acquiring* corporation like Citizens. The decisions differentiating between "sales" and "reorganizations" have generally arisen in litigation by the transferor corporation or its shareholders claiming nonrecognition of gain. But the reasons for differentiating sales from reorganizations are equally weighty when the effects upon the acquiring corporation are considered.

Section 362(b) of the Code generally provides a "carryover basis" for assets received by a corporation in a corporate reorganization. It says that "[i]f property [is] acquired by a corporation in connection with a reorganization * * *, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer." Suppose, for example, that Corporation A transfers assets with a fair market value of $40,000, but with a tax basis of $100,000, to Corporation B, which issues its notes in the amount of $40,000 to Corporation A or its shareholders.[22]

[22] The fair market value of Corporation A's assets might be lower than their tax basis, *e.g.*, because Corporation A's business was poor or because it was in failing circumstances. These conditions, of course, have not been uncharacteristic of the savings and loan industry in recent years.

Corporation B will take the assets with a basis of $100,000 if the transaction is held to be a reorganization, but with a basis of $40,000 if the transaction is held to be a sale. Thus, in the case of a reorganization, a transferee corporation receiving high-basis property will receive a *permanent* tax benefit, to be realized via higher depreciation deductions or in the computation of a loss upon disposition of the property acquired.[23] The result is that, when a corporation uses dollar obligations to acquire property, it is vital for proper administration of the tax laws to recognize that the transaction is a purchase for the amount of the dollar obligations issued. Otherwise, to use the figures of our example, the acquiring corporation will receive property with a basis of $100,000 by paying only $40,000. Cf. *Civic Center Finance Co.* v. *Kuhl*, 83 F. Supp. 251 (E.D. Wis. 1948), aff'd, 177 F.2d 706 (7th Cir. 1949).

In this case, Citizens acquired the assets of Commerce by issuing its dollar obligations to the former shareholders of Commerce, and by assuming dollar for dollar the savings accounts and other liabilities of Commerce. There is no reason why the assets Citizens has purchased should not take a basis in its hands measured by the dollar obligations it has undertaken, *i.e.*, their cost, and every reason why they should.

b. From petitioners' viewpoint, conversely, the merger plainly had all the earmarks of a "sale." Petitioners traded their Commerce stock for dollar

[23] This permanent tax benefit accruing to the transferee corporation is to be contrasted with the deferral benefit realized by the transferor's shareholders, for whom recognition of gain is simply postponed until the stock or securities received in the reorganization are sold.

obligations resembling bank deposits. Although those obligations in a technical sense carried with them certain proprietary features, it can scarcely be imagined that those features loomed large at the bargaining table, or that petitioners attached any real importance to them. The merger agreement (J.A. 54-71) evidently reflects a determination (presumably based on appraisals) that petitioners' stock was worth $12 a share, and the consideration petitioners received for each share was a $12 deposit in a savings account. If petitioners really thought that the accounts' "equity characteristics" had any material worth, Citizens presumably could have persuaded them to surrender each share of stock for a savings account deposit materially smaller than that sum. At all events, it is plain that the proprietary features accompanying the accounts did not "represent a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of the total consideration petitioners received.

Petitioners emphasize (Br. 16, 19) that they gained the right to vote as "members" of Citizens. They dismiss the voting rights of Citizens' borrowers, who clearly enjoy no proprietary interest, as "nominal" (Br. 18). But petitioners' own right to vote—one vote per $100 in their accounts—was limited to 400 votes (Pet. App. 27), so that they could not cast the 2,096 votes to which, had there been no arbitrary limit, their alleged "equity interest" should have entitled them. Their limited right to vote, moreover, was "infinitely dilutable" (Pet. App. 27) upon the addition of new borrowers, enrollment of new depositors, and any increase in existing depositors' amounts on deposit.[24] The right to vote in most savings and

[24] While acknowledging that Citizens' charter permits it to raise an unlimited amount of capital (Br. 20-21), petitioners

loan associations, as in mutual insurance companies, is usually more formal than substantial; the governing boards in fact tend to be self-perpetuating. See *York* v. *Federal Home Loan Bank Board*, 624 F.2d 495, 497 n.1 (4th Cir.), cert. denied, 449 U.S. 1043 (1980) ("[i]n practice, a depositor [in a mutual S&L] signs a proxy form when first opening an account which allows the officers of the association to cast [his] votes as they see fit."). The right to vote, in any event, is not in itself a proprietary interest. The graduates of many educational institutions, as well as the members of countless nonprofit organizations, vote to elect some or all of the members of the governing boards, but they can hardly be said to have a proprietary interest.

Petitioners stress that their savings accounts give them the opportunity to receive payments that Citizens styles "dividends." They make much of the fact that they are not "legally entitled" to these payments (Br. 22); that the payments are theoretically made "out of [the] profits of the enterprise" (*ibid.*); and that, according to Citizens' charter, "[t]he amount of the distribution on accounts, if any, is determined and declared periodically by the Board of Directors" (*id.* at 23). But petitioners see the form and miss the substance. They acknowledge that Citizens in fact "pays a fixed, preannounced rate on all accounts" (Pet. App. 27). They cite no instance where

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note that the charter grants the board of directors the power, inter alia, "[t]o reject any application for savings accounts or memberships" (J.A. 50). This provision has the ring of boilerplate, and petitioners do not suggest that the power is ever exercised in practice. In practice it seems most unlikely that it ever would be, for to do so would be to turn away business.

the Board of Directors has "determined and declared" any other rate. The "dividends" Citizens pays on its savings accounts are treated for federal tax purposes exactly like the interest paid by stock S&Ls and banks.[25] And common sense shows that this tax treatment accurately reflects the economic reality, for "[i]t is fanciful to suggest that depositors deciding where to put their money attach any weight to whether an institution is a mutual or a stock association" (Pet. App. 27-28). The market-

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[25] As noted above (see pages 20-21, *supra*), Citizens' dividends (unlike normal corporate dividends) are deductible by it (I.R.C. § 591) and do not qualify for the "dividend exclusion" in its depositors' hands (I.R.C. § 116(c)(1)). Petitioners note (Br. 23-24) that the Commissioner, in a pair of rulings issued thirty years ago and in a different context, once took the view that S&L account holders should treat their dividends as "dividends" rather than as "interest." Rev. Rul. 54-624, 1954-2 C.B. 16, 18; I.T. 4045, 1951-1 C.B. 34. Those rulings, however, were declared obsolete in 1972 and 1968 respectively. Rev. Rul. 72-621, 1972-2 C.B. 651; Rev. Rul. 68-100, 1968-1 C.B. 572. As we have observed (pages 18-25, *supra*), much has changed in the world of S&Ls (including significant changes in their treatment by Congress) since 1954, and the IRS has long since instructed taxpayers to report S&L "dividends" as interest, and not as dividends, on their personal tax returns. See IRS, *Instructions for Preparing Form 1040*, at 9 (1984); IRS, *Publication No. 17, Your Federal Income Tax* 35-36, 38 (1977) (for use in preparing 1976 tax returns). Instructions for preparation of information returns by payors likewise state that so-called "dividends" on "share accounts" in federal S&Ls should be reported on Form 1099-INT, and not on Form 1099-DIV. See IRS, *Instructions for Form 1096 (Annual Summary and Transmittal of U.S. Information Returns) and Forms 1099-ASC, 1099-B, 1099-DIV, 1099-G, 1099-INT, 1099-MISC, 1099-OID, 1099-PATR, and 5498*, at 5 (1984).

place ensures that "interest paid by mutual associations is competitive with interest paid by stock associations and commercial banks" (*id.* at 28), and the name attached to the payment is not likely to make any difference to the depositor.

Petitioners also stress (Br. 20) the fact that, if Citizens should ever be dissolved or wound up, all its savings account holders would share pro rata in the distribution of its assets. But that problematic interest, subject in any event to Citizens' power to redeem all or any part of its accounts, has been described by this Court (*Society for Savings* v. *Bowers*, 349 U.S. 143, 150 (1955)) in terms that demonstrate its insubstantiality:

> If a depositor withdraws from the bank, he receives only his deposits and interest. If he continues, his only chance of getting anything more would be in the unlikely event of a solvent liquidation, a possibility that hardly rises to the level of an expectancy. It stretches the imagination very far to attribute any real value to such a remote contingency, and when coupled with the fact that it represents nothing which the depositor can readily transfer, any theoretical value reduces almost to the vanishing point.

Indeed, it was on this basis that the Fourth Circuit recently ruled that a "member" (*i.e.*, depositor) of a federal mutual S&L could not block conversion into a stock form of organization, holding that depositors would not thereby be deprived of property rights since their "only actual rights, their rights as creditors of the association, will remain unchanged." *York* v. *Federal Home Loan Bank Board*, 624 F.2d at 500.

Ultimately, petitioners' claim to reorganization treatment seems to rest on the observation (Br. 6)

that Citizens' savings account holders own all the "equity" there is in the association. Under these circumstances, petitioners contend, failure to acknowledge the substantiality of their proprietary interest would be tantamount to holding that mutual institutions have no owners. It is this argument that seems to have persuaded other courts of appeals to reject the Commissioner's view of the transaction involved here. See *Capital Savings & Loan*, 607 F.2d at 976; *West Side Federal Savings & Loan*, 494 F.2d at 411.

The argument, however, misconceives the Commissioner's position. The Commissioner has never contended, either in this case (see page 5, *supra*) or in earlier cases (*e.g.*, *Capital Savings & Loan*, 607 F.2d at 972), that account holders in a mutual institution have *no* proprietary rights. See Rev. Rul. 69-6, 1969-1 C.B. 104. The government's position, rather, is that the proprietary rights acquired by the transferor corporation's stockholders in a transaction of this sort are too insubstantial to convert into a "reorganization" what bears all the earmarks of a "sale."

As the court of appeals aptly noted (Pet. App. 30), petitioners' argument fails to distinguish between the relevance of the savings accounts' proprietary features to Citizens' balance sheet on the one hand, and to the former Commerce stockholders on the other. There can of course be "little doubt that the passbook accounts are equity in the sense that they represent [Citizens'] entire capital structure" (Pet. App. 30). Business organizations like Citizens, whether or not they have stock outstanding, are presumptively owned by someone. The fact that an "equity component" to the savings accounts is a logical necessity from Citizens' point of view, however, does not mean that those equity features, from petitioners' point of

view, "represent[ed] a substantial part of the value" (*Minnesota Tea*, 296 U.S. at 385) of what they got. Under this Court's cases, it is not merely the *existence* of equity features, but their *materiality* and *substantiality*, that determine whether a merger is a "reorganization" or a "sale." See *id.* at 385-386; *John A. Nelson Co.* v. *Helvering*, 296 U.S. 374, 377 (1935).

The court of appeals correctly held that the equity features incorporated in petitioners' savings accounts had insubstantial value and that the accounts' "debt characteristics overwhelmingly predominate[d]" (Pet. App. 24). Indeed it is obvious, as a matter of common sense, that no one would pay anything extra, beyond the number of dollars on deposit, for the "equity features" accompanying petitioners' accounts, for one could acquire those equity features for free simply by using the same number of dollars to open an account in one's own name. Petitioners plainly regarded the accounts—as one would regard any checking or savings account—as the equivalent of cash. Petitioners' investment was virtually risk-free, being represented by short-term accounts that were federally insured.[36] The accounts were subject to withdrawal by petitioners and to retirement at the

[36] Petitioners note (Br. 22) that federal insurance for savings accounts in mutual institutions is generally limited to $100,000 per depositor. 12 U.S.C. 1728(a). This limitation, however, does not substantially diminish the relatively risk-free, and therefore non-equity, nature of such obligations. As noted above (see page 29, *supra*), moreover, Citizens' account holders are entitled to no voting rights with respect to deposits in excess of $40,000. To the extent that deposits over $100,000 are subject to some theoretical risk, therefore, they also lack the voting rights that petitioners elsewhere regard (Br. 19) as crucial to a true "equity" stake.

will of Citizens, and thus in no sense represented a permanent contribution to the association's capital. And the accounts' "market value" was clearly equal to the sum of their "debt characteristics," *i.e.*, the principal balance outstanding plus any interest accrued thereon.

In short, while petitioners clearly had an equity interest in Commerce, they just as clearly received what was in substance a creditor's interest in Citizens. Far from continuing the proprietary stake they previously held, they essentially cashed their investment out. Because the merger thus failed to evince the "continuity of proprietary interest" requisite to a "reorganization" under the Internal Revenue Code, the transaction was properly treated as a sale of petitioners' stock producing currently taxable gain.[37]

[37] Petitioners seek to characterize both the decision below (Br. 5-6, 14-15) and the Commissioner's position (Br. 5-6, 16) as making satisfaction of the "continuity of interest" requirement turn, erroneously, on "the perceived degree of change in the proprietary interest received," rather than on "the nature of the interest received" (Br. 16). This is a mischaracterization in both respects. As petitioners (Br. 15) correctly observe, this Court in *Minnesota Tea* held that "continuity of interest" does not depend on whether "the relationship of the [transferor] to the assets conveyed [has] substantially changed," but on whether the value of the equity interest received "represent[s] a substantial part of the value of the thing transferred.'" See 296 U.S. at 385-386 and page 16, *supra*. Consistently with *Minnesota Tea*, however, the Commissioner here does not seek to deny "reorganization" treatment because the proprietary interest petitioners acquired —relatively speaking—was a somewhat different form of proprietary interest than the one they gave up. The Commissioner seeks to deny "reorganization" treatment, rather, because the value of the proprietary interest petitioners acquired —viewed in absolute terms—was an insubstantial part of the

B. Even if the merger of Commerce into Citizens was a "reorganization," petitioners must recognize gain up to the fair market value of the non-equity interests that they received

1. A finding that an intercorporate exchange is a "reorganization" does not necessarily mean that no gain will be recognized to the transferors. Sections 354 and 356 of the Code impose strict limitations on the types of consideration that can be received tax-free. Section 354(a)(1), as noted above, affords non-recognition treatment only when "stock or securities in [one] corporation a party to [the] reorganization are * * * exchanged solely for stock or securities * * * in another corporation a party to the reorganization." Section 356(a)(1) provides that, if a taxpayer receives, besides "stock or securities," "other property or money," he must recognize his gain (if any) up to "the sum of such money and the fair market value of such other property." Section 354(a)(2)(B), moreover, imposes additional restrictions where "securities are received and no such securities are surrendered." In such situations, the securities received constitute "other property" (I.R.C. § 356(d)(1) and (2)), and gain must be recognized up to the fair market value thereof (I.R.C. §§ 354(a)(2), 356(d)(2)(B)).

In this case, petitioners traded their Commerce stock for Citizens savings accounts. Even if those

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total consideration they received, *i.e.*, did not "represent a substantial part of the value of the thing transferred" (*Minnesota Tea*, 296 U.S. at 385). The court of appeals based its decision on the same ground, concluding that the savings accounts' equity features had minuscule value (Pet. App. 25-32) and that their debt features "overwhelmingly predominate[d]" (*id.* at 24). This analysis is not inconsistent with, but is mandated by, this Court's decisions.

accounts are imbued with sufficient equity characteristics to satisfy the "continuity of proprietary interest" test, and thus to enable the overall transaction to qualify as a "reorganization," the effects of the reorganization exchange *on petitioners* must still be gauged by testing the consideration they received under Sections 354 and 356. Since petitioners surrendered only stock, they must recognize gain under those Sections to the extent that they acquired, not just "stock," but "securities," "money" or "other property."

The savings accounts petitioners received plainly do not constitute "stock" pure and simple. Rather, as the Commissioner pointed out below, they constitute "a hybrid interest, representing debt which is the equivalent of cash while, at the same time, having certain equity features" (Pet. App. 10). The "hybrid" nature of mutual savings accounts has been recognized, not only by the court of appeals below (Pet. App. 30, 32), but also by the Tax Court (*id.* at 14) and the other courts that have sustained "reorganization" treatment for mergers of this sort (*Capital Savings & Loan*, 607 F.2d at 974; *West Side Federal Savings & Loan*, 494 F.2d at 411). And leading commentators have recognized that, in the case of such "hybrid" interests, where "a single instrument * * * constitute[s] 'stock' but also embod[ies] rights of a 'nonstock' character," the transaction, "[t]o the extent of the value of the latter rights, * * * may be outside the reorganization provisions." Bittker & Eustice ¶¶ 14.11, 14.31, at 14-21, 14-95 n.242.

Here, petitioners clearly acquired "rights of a nonstock character" in addition to whatever proprietary interests they obtained in Citizens. What they ac-

quired, after all, were federally-insured savings accounts withdrawable more or less at will. Although petitioners' "rights of a nonstock character" have a strong flavor of cash equivalency, there is no need in this case to decide whether those rights should be considered "securities," "money," or "other property" (see page 12, *supra*). Since petitioners surrendered only stock, they must recognize gain to the extent they received anything but stock, regardless of how those non-equity interests are denominated (I.R.C. §§ 354, 356).

2. The Tax Court rejected this reasoning because it thought the equity and non-equity features of petitioners' savings accounts were inseparable. In the Tax Court's view, Sections 354 and 356 are meant to apply "where property qualifying for 'tax-free' exchange [is received] and, *in addition*, some other property or money is received" (Pet. App. 17 n.25 (emphasis original)). "Here," the Tax Court noted, "petitioners received only one type of property, [namely,] savings accounts * * * in the form of passbooks and time certificates" (*ibid.*). The court then cited *Capital Savings & Loan*, *supra*, for the proposition that "the cash deposit and proprietary rights represented by [mutual savings] accounts are not separable" (Pet. App. 17 n.25, citing 607 F.2d at 977), and concluded that petitioners' accounts, if they embodied any equity features at all, must necessarily be "stock," without more.

The Tax Court's reasoning betrays a curious formalism. It is of course true that a savings account is physically represented by a single piece of paper, and that one cannot detach and sell the account's equity component as one could detach and sell (say) a stock warrant that accompanies certain types of bonds.

But that does not mean that it is impossible to separate out the stock and nonstock *rights* that a savings account incorporates. Obviously, if petitioners had transferred their Commerce stock to a *stock* savings and loan association, and had received a package comprising stock and savings accounts, they would have to recognize gain up to the value of the latter. Similarly, if petitioners had transferred their Commerce stock to a *mutual* savings and loan association, and had received a package comprising cash and "membership rights," they would have to recognize gain in the amount of the former. It cannot seriously be contended that the result should be different here simply because petitioners got cash equivalents instead of cash, or because their creditor and membership rights were bound up in one piece of paper rather than in two.[28]

Differentiating "equity-flavored" instruments into their stock and nonstock components is not uncommon in the tax law, either in the reorganization area[29] or

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[28] Even if the Tax Court were correct in thinking that the physical inseparability of the accounts' "stock" and "nonstock" features should make a conceptual difference, it is hard to see why that court chose to characterize them the way it did. As the Tax Court recognized (Pet. App. 14), the accounts are a "hybrid" of debt and equity combined. If it were necessary to categorize the accounts as being exclusively one or the other, the logical approach seemingly would be to ascertain which features are dominant, and classify the whole accordingly. Here, it seems obvious that the accounts' debt features are predominant, so that they would not be "stock" even on the Tax Court's "inseparability" theory.

[29] See, *e.g.*, Rev. Rul. 69-265, 1969-1 C.B. 109, 109-110 (analyzing value of conversion rights incorporated in convertible preferred stock, and concluding that conversion rights represented "property other than voting stock" for purposes

in other areas,[30] and such a differentiation is clearly called for here. There is no reason why petitioners should qualify for *complete* nonrecognition of gain upon receipt of instruments that, if issued by any other entity, would produce recognition of gain in full, merely because the instruments they received happen to have *some* equity features. Rather, petitioners should be required, as taxpayers in all other kinds of reorganizations are required, to recognize gain up to the value of the non-equity interests received in the exchange. I.R.C. §§ 354(a)(2), 356(a)(1) and (d)(2)(B).[31]

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of Section 368(a)(1)(C)); Rev. Rul. 70-108, 1970-1 C.B. 78, 79 (analyzing value of additional stock-purchase rights incorporated in convertible preferred stock, and concluding that such rights "constitute[] property other than solely voting stock" for purposes of Section 368(a)(1)(B)). See generally Bittker & Eustice ¶ 14.31, at 14-94 to 14-101.

[30] See, *e.g.*, Rev. Rul. 61-18, 1961-1 C.B. 5, 7 (analyzing stock into true equity and "associated rights" for purposes of determining the character of gain realized upon sale).

[31] In taking the position that the stock and nonstock components of petitioners' savings accounts were not "separable," the Tax Court (Pet. App. 17-18 n.25) seemed to think that the Commissioner himself had taken that position in Rev. Rul. 69-6, 1969-1 C.B. 104. In that ruling, the Commissioner concluded that the merger of a stock S&L into a mutual S&L does not satisfy the "continuity of interest" requirement and hence constitutes a sale rather than a "reorganization" (1969-1 C.B. at 104-105). In stating the facts upon which the ruling was based, the Commissioner hypothesized a situation in which "Y's obligation to deliver cash deposits to X's shareholders is not severable from its obligation to deliver them a proprietary interest," since "[b]oth the cash equivalents and the proprietary interests are evidenced by passbooks" (1969-1 C.B. at 104). In that passage, however, the Commissioner was not announcing a principle of law, but simply providing an argumentative statement of the facts from the hypothetical taxpayer's point of view. In ruling that the merger was not a reorganization, the Commissioner clearly did separate out the stock and nonstock components of the savings accounts at issue, concluding that "[o]nly minimal value can be assigned to the proprietary interests" and that "the principal property received by [the transferor's shareholders] consists of withdrawable cash deposits as reflected by their passbook balances" (1969-1 C.B. at 104).

3. The record in this case would not permit one to value the equity features of petitioners' savings accounts if one's view were restricted to those features alone. Fortunately, however, that is not necessary, because the record rather clearly shows the value of the accounts' *non-equity* features. Those features consist of the right to withdraw $210,000 in cash, either on demand or at stated intervals, from Citizens. Since the accounts are virtually risk-free and bear an arm's-length interest rate, the fair market value of petitioners' right to withdraw should be equal —and is stipulated (see page 3 note 2, *supra*) to be equal—to the accounts' face value, viz., $210,000. Since the "fair market value" of petitioners' non-equity rights thus exceeds the gain petitioners realized ($153,000), they must recognize that gain in full (I.R.C. § 356(a)(1)).

This reasoning, of course, produces the same result, as far as petitioners and the other Commerce shareholders are concerned,[32] as our primary submission, *i.e.*, that the merger was not a "reorganization." See pages 13-35, *supra*. This reasoning also suggests that the value of the "equity components" of petitioners'

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[32] This reasoning would not prevent the corporate parties to the merger from enjoying whatever benefits "reorganization" treatment affords. See, *e.g.*, I.R.C. §§ 361, 362.

savings accounts is close to zero. But that merely goes to show that our primary submission is correct.

C. Denial of "reorganization" treatment in this case is supported by sound considerations of tax policy, and there are no countervailing factors in petitioners' favor

1. Common sense fully supports the court of appeals' construction of the Code's reorganization provisions, for any other interpretation would produce anomalous results. If the instant merger were held to be a "reorganization" and petitioners' savings accounts were held to be "stock," petitioners would receive a "substituted basis" in those accounts, *i.e.*, a basis equal to their basis in the Commerce stock they gave up. See I.R.C. § 358(a)(1). Since petitioners' basis in their Commerce stock was $57,000, they would receive a basis of $57,000 in cash equivalents of $210,000. This result would violate the rule, uniform throughout the Internal Revenue Code, that cash, when expressed in United States currency, always has a basis equal to its face value. See, *e.g.*, I.R.C. §§ 301(b), 358(a)(2), 362(c). Were this not so, one would realize gain or loss on making change.

The result petitioners seek would also create serious practical and administrative problems, as even those courts that have ruled against the Commissioner on this question have acknowledged. See, *e.g.*, *Capital Savings & Loan*, 607 F.2d at 977; Pet. App. 15-16 & n.21. Every time petitioners deposited money into their passbook savings accounts, they would have to keep the "new cash" (which would have a basis equal to its face value) separate from the "old cash" (which would have a substituted basis). Every time petitioners withdrew money from their passbook savings accounts, they would be required to recognize gain—a situation whose awkwardness would be even more graphic had petitioners received checking accounts instead of savings certificates (see page 25 note 19, *supra*). If petitioners' CDs matured, and their money were rolled over into another Citizens' account, it would be unclear whether gain should be recognized then, or whether recognition should be deferred until the money was ultimately withdrawn from the association. And if, as petitioners assert, their savings accounts represent "stock," each withdrawal would presumably have to be analyzed under Code Section 302 to determine whether it constituted a "redemption" of stock producing capital gain, or a distribution that was "essentially equivalent to a dividend" and thus taxable as ordinary income (see I.R.C. § 302(b)(1)). To undertake such an analysis, of course, would seem inconsistent with Sections 591 and 593(e), which, as noted above (pages 22-23, *supra*), contemplate that the Code's dividend and redemption rules do not apply to distributions or withdrawals from mutual savings accounts. But that seeming inconsistency only demonstrates the unsoundness of petitioners' basic position.

2. Petitioners contend that the Commissioner's position, upheld by the court below, produces a discriminatory result. As they note (Br. 16), the Commissioner has ruled that a mutual S&L can merge tax-free into a stock S&L (Rev. Rul. 69-646, 1969-2 C.B. 54), and that a mutual S&L can merge tax-free into another mutual S&L (Rev. Rul. 69-3, 1969-1 C.B. 103). Contrariwise, the Commissioner has ruled that a stock S&L cannot merge tax-free into a mutual S&L (Rev. Rul. 69-6, 1969-1 C.B. 104), and that ruling was sustained by the court of appeals here.

Petitioners contend (Br. 40-41) that these rulings collectively place "an unwarranted burden" on mutual institutions seeking to expand their business by acquiring other companies.

The Commissioner's rulings, obviously, do produce different results for different transactions, but the differences are entirely rational. When two mutual associations merge, the depositors simply exchange savings accounts in one for savings accounts in the other; the depositors' proprietary interests (such as they are) continue without alteration, and the depositors cannot meaningfully be said to have "sold" their accounts. See Rev. Rul. 69-3, 1969-1 B.C. at 104. When a mutual association merges into a stock association, the depositors exchange their savings accounts in the former for stock in the latter; the depositors' proprietary interests continue (indeed, are enhanced), and the transaction takes the classic "reorganization" form of an asset acquisition for stock. See *Minnesota Tea*, 296 U.S. at 385. Here, by contrast, petitioners have exchanged their stock in Commerce for savings accounts in Citizens; they have, in essence, liquidated their equity investment, and the transaction has taken the classic "sale" form of an asset acquisition for cash. See *Pinellas Ice*, 287 U.S. at 469-470. In distinguishing this transaction from the other two, the Commissioner's rulings are neither discriminatory nor inconsistent.

3. Finally, petitioners contend (Br. 8-9, 30-38) that there *must* be a way in which a stock S&L can merge into a mutual S&L without adverse tax effects, unless the Internal Revenue Code is to be judged quixotic. Although some other courts seem to have found this idea persuasive (see, *e.g.*, *Capital Savings & Loan*, 607 F.2d at 976), it is completely misguided.

Nothing in the Internal Revenue Code suggests that Congress ever recognized any imperative that stockholders be permitted to dispose of their stock for dollar obligations without recognizing gain, or that corporations be permitted to purchase assets for dollar obligations and take a basis in those assets different from their cost. Indeed, the legislative history demonstrates Congress's understanding that, "[i]n the case of mergers or reorganizations of savings and loan associations," the outcome "depends on whether for tax purposes the merger is characterized as a tax-free reorganization or as a taxable sale." [33] Congress plainly recognized that an amalgamation of S&Ls employing the mechanisms of merger is not necessarily tax-free, and it is hard to imagine a transaction more like a "sale" than this one.

In any event, even if petitioners' idea were not misguided, it has no application here. On the very day of the merger involved in this case—July 1, 1976—a provision of the National Housing Act (enacted

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[33] S. Rep. 91-552, 91st Cong., 1st Sess. 168 (1969) (discussing Tax Reform Act of 1969, Pub. L. No. 91-172, § 432(b), 83 Stat. 622). The provision the Senate Finance Committee was discussing concerned restoration of a bad-debt reserve to the acquired S&L's income, a result that is mandated in the case of a "sale" but not of a "reorganization." The Committee stated (S. Rep. 91-552, *supra*, at 169) that the provision was intended to be declaratory of existing law, and was made explicit in order to avoid the necessity of taxpayers' obtaining advance IRS rulings to that effect. This provision is significant here because it was, with respect to transactions occurring after its effective date (July 11, 1969), a statutory codification of the result reached as to pre-1969 facts in *Home Savings & Loan Ass'n* v. *United States*, 514 F.2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975), the decision which the court of appeals in this case followed and applied. See Pet. App. 25-31.

three years earlier)[34] took effect, which for the first time permitted a federal mutual savings and loan association to convert into a stock form of organization. See *York* v. *Federal Home Loan Bank Board*, 624 F.2d 495 (4th Cir. 1980). Had petitioners and their fellow Commerce shareholders desired to effectuate a reorganization, and exchange their Commerce shares for stock rather than dollars, it would have been possible to convert Citizens into a stock association and proceed with a reorganization on which no gain would have been recognized.[35] In that event, of course, petitioners would not have been able to cash out their equity investment, but that is not something that the Code's reorganization provisions were designed to permit them to do tax-free.

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[34] Pub. L. No. 93-100, § 4, 87 Stat. 343, adding 12 U.S.C. 1725(j).

[35] The Bank Board's regulations governing applications for permission to convert from a mutual to a stock form of federally-chartered savings and loan association are set forth at 12 C.F.R. 552.1, 552.2 (1976). These regulations were promulgated on May 14, 1975 (40 Fed. Reg. 20945), in ample time to have permitted Citizens to apply for conversion before the July 1, 1976, effective date of the merger.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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AUGUST 1984

APPENDIX

(Statutes as effective in 1976)

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):

Sec. 116. *Partial exclusion of dividends received by individuals.*

(a) *Exclusion from gross income.*

Gross income does not include amounts received by an individual as dividends from domestic corporations, to the extent that the dividends do not exceed $100. If the dividends received in a taxable year exceed $100, the exclusion provided by the preceding sentence shall apply to the dividends first received in such year.

* * * * *

(c) *Special rules for certain distributions.*
For purposes for subsection (a)—

(1) Any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.) shall not be treated as a dividend.

* * * * *

Sec. 354. *Exchanges of stock and securities in certain reorganizations.*

(a) *General rule.*

(1) *In general*

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) *Limitation*

Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

* * * * *

Sec. 356. *Receipt of additional consideration.*

(a) *Gain on exchanges.*

(1) *Recognition of gain*

If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

* * * * *

(d) *Securities as other property.*

For purposes of this section—

(1) *In general*

Except as provided in paragraph (2), the term "other property" includes securities.

(2) *Exceptions*

(A) *Securities with respect to which nonrecognition of gain would be permitted*

The term "other property" does not include securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) *Greater principal amount in section 354 exchange*

If—

(i) in an exchange described in section 354 (other than subsection (c) or (d) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (c) if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

* * * * *

Sec. 368. *Definitions relating to corporate reorganizations.*

(a) *Reorganization.*

(1) *In general*

For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

* * * * *

Sec. 581. *Definition of bank.*

For purposes of sections 582 and 584, the term "bank" means a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State, a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, Territorial, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

Sec. 591. *Deduction for dividends paid on deposits.*

In the case of mutual savings banks, cooperative banks, and domestic building and loan associations and other savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

Sec. 593. *Reserves for losses on loans.*

* * * * *

(e) *Distribution to shareholders.*

(1) *In general*

For purposes of this chapter, any distribution of property (as defined in section 317(a)) by a domestic building and loan association to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made—

(A) first out of its earnings and profits accumulated in taxable years beginning after December 31, 1951, to the extent thereof,

(B) then out of the reserve for losses on qualifying real property loans, to the extent additions to such reserve exceed the additions which would have been allowed under subsection (b)(4),

(C) then out of the supplemental reserve for losses on loans, to the extent thereof,

(D) then out of such other accounts as may be proper.

This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association, except that any such distribution shall be treated as made first out of the amount referred to in subparagraph (B), second out of the amount re-

ferred to in subparagraph (C), third out of the amount referred to in subparagraph (A), and then out of such other accounts as may be proper. This paragraph shall not apply to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies.

* * * * *

Sec. 1002. *Recognition of gain or loss.*

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

Sec. 7701. *Definitions.*

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * *

(19) *Domestic building and loan association*

The term "domestic building and loan association" means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which either (i) is an insured institution within the meaning of section 401(a) of the National Housing Act (12 U.S.C., sec. 1724(a)), or (ii) is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest of which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments

dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary, and

(x) property used by the association in the conduct of the business described in subparagraph (B).

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property.

* * * * *

12 U.S.C. (1976 ed.):

Sec. 1464. *Federal Savings and Loan Associations.*

(a) *Organization authorized.*

In order to provide local mutual thrift institutions in which people may invest their funds and in order to provide for the financing of homes, the Board is authorized, under such rules and regulations as it may prescribe, to provide for the organization, incorporation, examination, operation, and regulation of associations to be known as "Federal Savings and Loan Associations," and to issue charters therefor, giving primary consideration to the best practices of local mutual thrift and home-financing institutions in the United States.

(b) *Capital; members of the association; voting rights; payment of savings accounts and withdrawals; nontransferable order or authorizations; authorization to borrow, give security, act as surety, and issue notes, bonds, debentures, or other obligations.*

(1) An association may raise capital in the form of such savings deposits, shares, or other accounts, for fixed, minimum, or indefinite periods of time (all of which are referred to in this section as savings accounts and all of which shall have the same priority upon liquidation) as are authorized by its charter or by regulations of the Board, and may issue such passbooks, time certificates of deposit, or other evidence of savings accounts as are so authorized. Holders of savings accounts and obligors of an association shall, to such extent as may be provided by its charter or by regulations of the Board, be members of the association, and shall have such voting rights and such other rights as are thereby provided. Except as may be otherwise authorized by the

association's charter or regulation of the Board in the case of savings accounts for fixed or minimum terms of not less than thirty days, the payment of any savings account shall be subject to the right of the association to require such advance notice, not less than thirty days, as shall be provided for by the charter of the association or the regulations of the Board. The payment of withdrawals from savings accounts in the event an association does not pay all withdrawals in full (subject to the right of the association to require notice) shall be subject to such rules and procedures as may be prescribed by the association's charter or by regulation of the Board, but any association which, except as authorized in writing by the Board, fails to make full payment of any withdrawal when due shall be deemed to be in an unsafe or unsound condition to transact business within the meaning of subsection (d) of this section. Savings accounts shall not be subject to check or to withdrawal or transfer on negotiable or transferable order or authorization to the association, but the Board may by regulation provide for withdrawal or transfer of savings accounts upon nontransferable order or authorization.

(2) To such extent as the Board may authorize by regulation or advice in writing, an association may borrow, may give security, may be surety as defined by the Board and may issue such notes, bonds, debentures, or other obligations, or other securities (except capital stock) as the Board may so authorize.

* * * * *

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No. 83-832

In the Supreme Court

OF THE

United States

OCTOBER TERM, 1984

HAROLD T. PAULSEN, ET UX.,
Petitioners,

VS.

COMMISSIONER OF INTERNAL REVENUE

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

REPLY BRIEF FOR THE PETITIONERS

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QUESTION PRESENTED

Whether the merger of a state stock-type savings and loan association into a federal mutual savings and loan association, in which all the stock of the state association is exchanged for ownership savings accounts representing share interests in the federal mutual association, qualifies as a reorganization upon which taxable gain is deferred under sections 368(a)(1)(A) and 354(a)(1) of the Internal Revenue Code of 1954, as amended (the "Code").

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ARGUMENT.

Respondent's only argument in his brief appears to be that this merger *should* be currently taxed because, in respondent's view, petitioners and the other former shareholders of Commerce could easily liquidate the proprietary interest they received through the merger of Commerce into Citizens Federal. That is not the law; nor has respondent cited any authority which supports such a proposition.[1] If liquidity were the test, many reorganizations never questioned by respondent would be disqualified by the marketability, or redeemability, of the stock received by the acquired entity's shareholders.

I

RESPONDENT HAS FAILED TO ADDUCE ANY STATUTORY OR JUDICIAL AUTHORITY WHICH SUPPORTS HIS CONTENTION THAT THE MERGER AT ISSUE WAS NOT A REORGANIZATION.

A. Respondent's Interpretation of the Continuity of Proprietary Interest Requirement Has No Basis in the Law.

To reach the result he desires in this case, respondent urges upon the Court a radical departure from the well-accepted meaning and proper application of the "continuity

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[1]That the perceived liquidity of petitioners' investment is the core of respondent's argument is illustrated by respondent's own terminology. While never actually calling the accounts "debt," because as even respondent concedes, they clearly do represent a proprietary stake in Citizens, respondent resorts to terms such as "cash *equivalent*" (Resp. Br. 17), "*functionally equivalent*" to debt (Resp. Br. 17), "*substantially identical*" to debt (Resp. Br. 17), "*essentially the equivalent* of cash" (Resp. Br. 26), "*essentially* bank deposits" (Resp. Br. 26), "*resembling* bank deposits" (Resp. Br. 29), "*essentially cashed* their investment out" (Resp. Br. 35), "non-equity *features*" (Resp. Br. 38, 41), "*hybrid* interest" (Resp. Br. 37), "*strong flavor of* cash equivalency" (Resp. Br. 38), "debt *features*" (Resp. Br. 9). For the first time, respondent also adopts the label "dollar obligations" to refer to petitioners' investment in Citizens, a term which has no legal meaning of which we are aware.

of proprietary interest" requirement. As this Court has held, and respondent concedes (Resp. Br. 35, n. 27), the test for continuity of proprietary interest is not whether "the relationship of the [exchanging shareholders] to the assets conveyed [has] substantially changed." *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935). Rather, the focus must be on the *nature* of the interest received.

In a footnote, respondent denies that "the decision below ... and the Commissioner's position ... mak[e] satisfaction of the 'continuity of interest' requirement turn, erroneously, on 'the perceived degree of change in the proprietary interest received,' rather than on 'the nature of the interest received'" (Resp. Br. 35, n. 27). Respondent's denial, however, is undercut by his failure to explain how the test can be satisfied when a share account in a mutual savings and loan association is exchanged for a share account in another mutual asociation, but *not* when the same interest is received in exchange for stock in a stock savings and loan association. *Compare* Rev. Rul. 69-3, 1969-1 C.B. 103 *with* Rev. Rule 69-6, 1969-1 C.B. 104. Indeed, respondent's explanation of his ruling position makes it clear that he *is* relying "on 'the perceived degree of change in the proprietary interest received,' rather than on 'the nature of the interest received'" (Resp. Br. 35, n. 27). He states that "[w]hen two mutual associations merge ... the [exchanging account holders'] proprietary interests ... *continue without alteration*," and that [w]hen a mutual association merges into a stock association, the [exchanging account holders'] ... proprietary interests continue (*indeed, are enhanced*) ..." (Resp. Br. 44) (emphasis added). On the other hand, he contends that when a stock association merges into a mutual association, receipt of the *same* proprietary interest by the exchanging account holders constitutes a "liquidat[ion of] their equity investment...." *Id.* (emphasis added).

In an obvious effort to avoid the holding in *Minnesota Tea* and to divert attention from the erroneous standard the court of appeals below applied to this transaction, respondent offers yet another interpretation of the continuity of proprietary interest requirement. Quoting out of context only a portion of the language used by this Court in *Minnesota Tea,* respondent argues that '[t]he equity stake petitioners acquired in Citizens did not 'represent a substantial part of the value' [the Court's language] *of what they got in the merger* [respondent's language]" (Resp. Br. 9) (emphasis added). From that premise, respondent concludes that the continuity of proprietary interest requirement has not been satisfied because "[u]nder this Court's cases, it is not merely the *existence* of equity features, but their *materiality* and *substantiality,* that determine whether a merger is a 'reorganization' or a 'sale'" (Resp. Br. 34) (emphasis in original).

The language of *Minnesota Tea* from which respondent quotes reads:

> And we now add that this interest [in the affairs of the acquiring company] must be definite and material; it must represent a substantial part of the value *of thing transferred.* This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation.

296 U.S. at 385 (emphasis added).[2] On the next page of the Court's opinion, Mr. Justice McReynolds repeats that "so long as the taxpayer received an interest in the affairs of the transferee [corporation] which represented a material part of the value *of the transferred assets,*" the continuity of proprietary interest requirement would be satisfied. *Id.* at 386 (emphasis added).

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[2]The exchanging shareholders in *Minnesota Tea* received voting trust certificates representing common stock in the transferee corporation worth approximately $540,000 and, in addition, cash in the amount of $425,000. 296 U.S. at 384.

Respondent's adaptation of the Court's language to suit his argument is incorrect. Contrary to respondent's assertion, the Court did *not* espouse the fragmentation and valuation of the "equity features" and "non-equity features" of the consideration received which represented an "interest in the affairs of the transferee" corporation. Nor did the Court state that the "equity features" must reflect a "substantial part" of the value of the proprietary interest *received*. Instead, the Court stated that a *material portion* of the stock or assets *exchanged must be exchanged* for consideration which confers a continuing proprietary interest in the transferee corporation upon the exchanging shareholders. In *Minnesota Tea*, those shareholders received cash, a separate form of consideration, *in addition to* stock representing a proprietary interest in the transferee. The Court was therefore concerned with the effect of the cash consideration which represented no continuing proprietary interest in the business enterprise. Where, as here, only *one* type of consideration is received by the exchanging shareholders for *all* of their stock, and that type of consideration is the only form of equity capital issued by the transferee, the continuity of proprietary interest requirement is satisfied. No court, until the Ninth Circuit below, has ever held otherwise.

Respondent's misstatement of the principle enunciated in *Minnesota Tea* is a disguised attempt to apply the very standard which he concedes is erroneous under this Court's decisions (*See* Resp. Br. 35, n. 27). Under a slightly different cover, respondent is still arguing that the relationship of the taxpayer to the assets transferred, which relationship is defined by the terms of the proprietary interest received, must continue substantially unchanged. Otherwise, the position he takes in his published rulings is inconsistent with his new analysis.

If, as respondent contends, the continuity of proprietary interest test is satisfied only when the "equity features" of the consideration received " 'represent a substantial part of [the consideration's] value' " (Resp. Br. 9), and if the "equity features" of a share account in a mutual savings and loan association do not meet that test, then respondent's published ruling that a merger of two mutual savings and loan associations is a reorganization must be wrong. There, the consideration received by the exchanging shareholders is the *same* consideration received by the petitioners here. *See* Rev. Rul. 69-3, 1969-1 C.B. 103. Its "equity features" therefore have the same "value" compared to what respondent considers to be its "non-equity features." Consequently, if the test is not satisfied here because those "equity features" lack sufficient "value," it also cannot be satisfied in the case of a mutual-into-mutual merger.

To our knowledge, respondent has never refused reorganization treatment to mergers of mutual associations into mutual associations. If his new version of the continuity of proprietary interest requirement is correct, however, it follows that all of those mergers are taxable sales of assets on which the acquired associations are required to recapture bad debt reserves, depreciation, investment tax credit and tax benefit items as ordinary income, as well as recognize any gain or loss on the sale of the assets. Respondent's new test would thus discriminate against all federal savings and loan associations organized in mutual form by denying them the ability to reorganize without incurring a substantial tax except when acquired by a stock association. Congress could not have intended such a result.[3]

---

[3]Respondent points out that Congress was aware in the late 1960's that restoration of bad debt reserves into income by acquired savings and loan associations would be necessary in the case of sales, *but not reorganizations*, of those associations. (Resp. Br. 45 & n. 33). Respondent's suggestion, however, that this supports his position

Finally, despite respondent's repeated assertions to the contrary (Resp. Br. 10, 41), petitioners have never "stipulated" to the value of what respondent calls "nonequity features." Nor is respondent's inability to value the "equity features" of petitioners' accounts the fault of the "record in this case," on which respondent lays the blame (Resp. Br. 41). It derives, instead, from the circularity of respondent's argument. Once he determines that the "value" of the so-called "non-equity features" of petitioners' accounts is defined by the amount that petitioners might realize if they liquidated their investment, nothing can, by definition, be left to allocate to the "equity features." Indeed, petitioners would necessarily lose, and have no further reason to be interested in, those "equity features" upon the disposition of their accounts. The same is true when any share of stock is redeemed or sold. Under respondent's reasoning, the amount that could be realized upon disposition of the stock would be the value of its "non-equity features." His theory would therefore assign no value to the "equity features" of a share of stock in any corporation, and petitioners are in no different position than would be any other stockholder subjected to his analysis.[4]

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will not withstand scrutiny. The only published case law in existence at that time addressing whether a transaction such as the one at issue constituted a nontaxable reorganization was *Estate of W. T. Hales v. Commissioner*, 40 B.T.A. 1245 (1939). In that case, respondent conceded that the transaction was a reorganization. Furthermore, respondent's implication that Congress was somehow omniciently approving in advance the Ninth Circuit's 1975 decision in *Home Savings & Loan Ass'n v. United States*, 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975) is not only absurd, it is irrelevant to this case. *Home Savings* did not involve mutual savings and loan associations. It dealt solely with stock associations in which all of the stockholders had sold their stock for cash prior to the merger.

[4]This is no doubt why, "in litigated cases, classification has been treated as an all-or-nothing question, so that instruments have not been fragmented into part equity and part debt." B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 4.01, at 4-7 (4th ed. 1979). *See also, Monon Railroad v. Commissioner*, 55 T.C. 345, 356 (1970).

B. The Code Sections Upon Which Respondent Relies Have No Bearing on the Reorganization Provisions in Issue Here.

Respondent seeks support for his position from two Code sections which were enacted (i) to provide a specific tax deduction to mutual savings and loan associations that would otherwise not have been available, because they do not pay "interest" to their account holders (section 591); and (ii) to specify the proper use and taxation of reserves for losses on loans (section 593). From the enactment of these two sections, respondent concludes that "[t]he evolution of the relevant Code provisions reveals a deliberate Congressional intent increasingly to assimilate [mutual savings and loan associations] and their members to banks and their depositors" (Resp. Br. 18). He then argues that mutual savings and loan associations should therefore be denied the benefit of the reorganization provisions available to those same banks!

In his fervor to corroborate his assertion that sections 591 and 593 are relevant, respondent first mischaracterizes the impact of section 591. He then suggests, erroneously, that the provisions of section 593(e) (formerly, section 593(f)) governing distributions of "property" to "shareholders with respect to their stock" do not apply to mutual savings and loan associations (Resp. Br. 22-23 & n. 17). From this respondent concludes that other Code provisions dealing with distributions of property by corporations, such as section 302 (redemptions), section 331 (liquidations) and section 346 (formerly, partial liquidations, now containing certain special rules and definitions), do not apply to distributions by *mutual* savings and loan associations. *Id.* Respondent is wrong on both counts.

The predecessor to section 591 of the Code, as first enacted in 1951, allowed mutual savings and loan associations (included within the term "domestic building and loan associations"), together with certain other financial institutions, a deduction for "amounts paid . . . or credited . . . as dividends on . . . deposits or withdrawable accounts. . . ." Revenue Act of 1951, ch. 521, § 313(f), 65 Stat. 491, amending 1939 Code § 23(r), 53 Stat. 16. In the Revenue Act of 1962, Pub. L. No. 87-834, § 6(f), 76 Stat. 984, section 591 was amended to add the words "or interest," reflecting the general liberalization of language beginning to be used by the institutions and the public at the time, but not in response to any change in the legal rights of accounts or account holders receiving the distributions. *See Midwest Savings Ass'n v. Commissioner*, 75 T.C. 262 (1980) (discussing in detail the legislative history surrounding the enactment of and the 1962 amendment to section 591).[5]

The deduction allowed under section 591 is not applicable to true interest payments. The interest paid by banks and by stock savings and loan associations on their deposits is deductible under section 163 of the Code, when paid *or accrued. See id.* at 266-67 (quoting *Hudson City Savings Bank v. Commissioner*, 53 T.C. 70, 74-75 (1969)). On the other hand, distributions deductible under section 591 must be at the complete disposal of the account holder, "withdrawable on demand," before the association will be allowed a deduction. I.R.C. § 591(a). Dividend distributions made by mutual savings and loan associations, whether interest-like or not, are deductible under section 591. *Midwest Savings*

[5]It is not unusual for Congress to grant special deductions for dividends paid on stock. *See, e.g.*, former section 583 of the Code (repealed effective for taxable years beginning after December 31, 1976), providing a deduction for dividends paid by banks, trust companies and incorporated domestic insurance companies on their "preferred stock" owned by the United States or any instrumentality thereof exempt from federal income taxes.

Ass'n, 75 T.C. at 269.[6]

Section 593(e)(1) of the Code, to which respondent refers, states, in relevant part:

> For purposes of this chapter [normal taxes and surtaxes, including all corporate tax provisions], any distribution of property (as defined in section 317(a)) by a *domestic building and loan association . . . to a shareholder with respect to its stock, if such distribution is not allowable as a deduction under section 591, shall be treated as made* —
>
> (A) . . . [first out of post-1951 earnings and profits, and then out of certain bad debt reserves and other accounts] . . .
>
> . . . .
>
> This paragraph shall apply in the case of any distribution in redemption of stock or in partial or complete liquidation of the association . . . [except that the order of funds from which these distributions are deemed made is altered]. This paragraph shall not apply to any transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies. . . .

[6]*Midwest Savings* illustrates the type of ownership rights which respondent would deny exist in Citizens Federal account holders. There, two mutual savings and loan associations agreed to merge. Pursuant to the merger agreement, exchanging account holders were offered a choice of one of three options, each assuring them a 4 percent bonus over and above the withdrawal values of their accounts as of a certain date. 75 T.C. at 264-65. Thus, each exchanging account holder was entitled to receive an amount that was presumably equal to the excess value of his pro rata interest in his association's net assets over the value of the interest he would receive in the acquiring association's assets if that interest were based on the withdrawal value of his account. The account holders' elected board of directors who negotiated the merger took full advantage of the account holders' ownership rights. Yet the court of appeals below gave those same legal rights "no weight" in its decision in this case (Pet. App. 28).

From the face of the statute, it is obvious that section 593(e) applies (i) to all domestic building and loan associations, including those organized in mutual form,[7] (ii) to all distributions of property[8] to a shareholder of such an association *with respect to its stock, unless the distribution is deductible under section 591*; and (iii) treats withdrawable share accounts and deposits as stock and the holders of those accounts as shareholders, since there would be no other reason for section 593(e) to exclude distributions deductible under section 591.

Distributions which are not deductible under section 591, but are instead within section 593 and are therefore subject both to section 593 and to the normal Code provisions governing distributions to corporate shareholders (Resp. Br. 22), include distributions in redemption of the account or in partial or complete liquidation of the association. *See* Rev. Rul. 57-39, 1957-1 C.B. 198 ("[U]ndistributed earnings of a domestic building and loan association distributed in complete liquidation to the holders of withdrawable shares in the association are *not deductible* by the association as dividends paid within the meaning of section 591 of the Internal Revenue Code of 1954, in computing its taxable income for the year of liquidation.") (emphasis added). If those distributions are considered to be made out of the bad debt reserves described in section 593(e)(B) or (C), section 593(e)(2) (Reply Br. App. 2) requires that they be recaptured into income. On liquidation, for example, a mutual savings and loan association would be required to recapture its unused bad debt reserves under section 593,

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[7]Federal mutual savings and loan associations are generally "domestic building and loan associations" entitled to employ the bad debt reserve rules of section 593. *See* I.R.C. § 7701(a)(19) (Resp. Br. App. 6a-9a).

[8]The term "property" is defined by Code section 317(a) to include money. I.R.C. § 317(a).

as well as investment tax credit and depreciation under other Code sections in the same manner as would any other corporation. Respondent's reliance on this line of argument to support his case is therefore badly misplaced.

C. The 1968 Amendment to Section 5(b) of the Home Owners' Loan Act of 1933 Did Not Change the Capital Structure of Federal Mutual Savings and Loan Associations or the Ownership Rights of Their Account Holders.

Respondent charges that "[i]n 1968, . . . Congress decided that the formal capital structure of federal savings and loans should be brought more nearly into conformity with the public view of those institutions" (Resp. Br. 24). He implies that the 1968 amendment to section 5(b) of the Home Owners' Loan Act of 1933, 48 Stat. 132, 12 U.S.C. § 1464(b) (the "1968 amendment"),[9] altered the capital structure of those institutions and therefore converted their account holders into bank depositors and their accounts into debt. But Congress made no such change. The change made was one in authorized *terminology*, and the legal rights of account holders in federal associations continue to be defined by the charters of those associations and the federal regulations governing them. 12 U.S.C. § 1464(b)(1) (1976 ed.) (Resp. Br. App. 10a-11a). *See* H.R. Rep. No. 1585, 9th Cong., 2d Sess. 107 & 152 (1968) (stating that the amendment was intended to "allow *the use of such terms as* 'savings deposits' with reference to accounts in Federal savings and loan associations," and that the section authorizing use of the new terminology "does not represent any radical innovations in our financial systems . . . .") (emphasis added).

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[9]Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 1716(a), 82 Stat. 608.

The 1968 amendment came about in the following manner. In 1949, the regulations prescribing charters for federal mutual savings and loan associations began to use the term "savings account" to describe a member's share interest in the association, because that term was in common public usage and because of pressure from savings and loan groups to be allowed to use the same terminology as banks, despite the legal differences in their accounts.[10]

In 1958, a group of bankers challenged the regulations allowing mutual savings and loan shares to be called "savings accounts" as "unauthorized" and "illegal" under section 5(b) of the Home Owners' Loan Act, which, they argued, only authorized the associations to raise capital by payments on "shares." *Wisconsin Bankers' Ass'n v. Robertson*, 294 F.2d 714 (D.C. Cir.), *cert. denied*, 368 U.S. 938 (1961), *reh'g denied*, 368 U.S. 979 (1962). The bankers contended that the provision in the regulations allowing federal savings and loan associations to raise capital by payments on "savings accounts" instead of on "shares" as the statute required converted an account holder to a "creditor of the association just as a holder of a savings account in a bank is a creditor of the bank." *Id.* at 716.

The court of appeals, looking beyond the formal terminology to the substantive legal rights of the account holders and to the definition of a "savings account" as the holder's interest in the capital of the association, rejected the bankers' claim. It found that the accounts, despite what they were called, had "the same meaning as the word 'shares' in the statutory provision governing the raising of capital." *Id.* at 716. Judge (now Chief Justice) Burger explained more fully in his concurring opinion:

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[10]Later, the term "deposit" came to be used by the public in much the same manner.

> The capital of a federal savings and loan association *is* raised by payments on share interests. Calling them "payments" on "savings accounts" does *not alter their legal status.* That the payment may be regarded . . . as a "deposit" or even called at times a deposit by the association does not make it a legal counterpart of a deposit in a bank. The "depositor" in a federal association is not a creditor as is a depositor in a bank.

Id. at 717 (emphasis added).

The 1968 amendment upon which respondent places such emphasis was enacted to put an end to the disputes between banking groups and savings and loan groups over the use of terminology such as "savings accounts" and "deposits," and was a direct outgrowth of the decision in *Wisconsin Bankers.* Congress responded by making it clear that federal savings and loan associations could use the same terminology as banks. That is, they could

> raise [their] *capital* in the form of such saving deposits, shares or other accounts, . . . (all of which are referred to in this section as savings accounts and all of which shall have the same priority upon liquidation) *as are authorized by* [*their*] *charter* or by regulations . . . and may issue such passbooks, time certificates of deposit, *or other evidence of savings accounts* as are so authorized.

12 U.S.C. § 1464(b) (1976 ed.) (Resp. Br. App. 10a-11a).

Like the regulations objected to in *Wisconsin Bankers*, the 1968 amendment did not change the capital structure of federal mutual associations. The language of the statute clearly states that the legal rights of account holders, whether denominated "savings account holders" or "depositors," are governed by the association's charter, and petitioners' accounts are defined in the regulations just as they were at the time of *Wisconsin Bankers* as "the monetary

interest of the holder thereof in the capital of a Federal mutual association. . . ." 12 C.F.R. § 541.4 (1976 ed.) (Reply Br. App. 1); *see also* 12 C.F.R. § 541-3 (1976 ed.) (Reply Br. App. 1). This case turns on the same debt-versus-equity characterization which was key to resolution of the issue in *Wisconsin Bankers*. The 1968 amendment to section 5(b) is therefore irrelevant to the Court's decision.

II

THE SAME FACTORS WHICH LED THIS COURT TO CHARACTERIZE THE ACCOUNTS IN TCHEREPNIN V. KNIGHT AS STOCK ARE CONTROLLING IN THIS CASE.

Respondent endeavors to minimize the importance of this Court's holding in *Tcherepnin v. Knight*, 389 U.S. 332 (1967), by dismissing it as simply a case construing another statute which "turned upon the language and purposes of the particular statute[] under which [it] arose" (Resp. Br. 18). But respondent misses the point. The "narrow question for decision in [*Tcherepnin* was] whether a withdrawable capital share in [a state mutual] savings and loan association [was] a 'security' within the meaning of the Securities Exchange Act of 1934. . . ." *Id.* at 332. Nevertheless, the Court found it necessary to "look first to the legal character imparted to those shares by [the governing] statute" to determine whether they were within any of the listed categories of instruments designated as "securities" by section 3(a)(10) of the 1934 Act, and therefore qualified their holders as "investors" entitled to its protection. *Id.* at 336.

The "legal character" of the accounts at issue in *Tcherepnin* was substantially identical to the "legal character" of the Citizens Federal accounts received by petitioners in this case. The accounts there represented shares in the capital of the association. They entitled their holders to vote, they

did *not* entitle their holders to a fixed rate of return, but rather to dividends declared by the board of directors and which were contingent upon profits, they were withdrawable, but only under certain specified conditions, as are petitioners' accounts[11] and holders did not become creditors of the association when they filed applications for withdrawal. Finally, the accounts represented all the equity capital in the association. *Id.* at pp. 337-340, 344. The Court found that "[t]hese same factors make the shares "stock" under § 3(a)(10)." *Id.* at 339.

The term "stock" is not defined in the Securities Exchange Act, as it is in the Code, to include "shares in an association." Yet the Court, even without such guidance, found that "form should be disregarded for substance and the emphasis should be on economic reality" (*Id.* at 336). Based on that principal, which applies with equal force in the tax law, the Court determined that the substance and economic reality of accounts such as those at issue here made them "stock." In so holding, the Court flatly rejected the conclusion of the Court of Appeals for the Seventh Circuit that the account holders' " 'relationship with the enterprise

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[11]Respondent persists in labelling Citizens Federal's accounts "demand deposits." Not only do petitioners' legal rights with respect to the accounts bely such a characterization, but in 1976, federal mutual savings and loan associations were *prohibited* from issuing any "demand deposits." *See* H.R. Rep. No. 1585, 90th Cong. 2d Sess. 152 (1968) ("Demand deposits are prohibited.") Respondent also mistates the facts (as did the Ninth Circuit in its opinion) as to Citizens Federal's right to redeem its accounts (Resp. Br. 3). If Citizens were to call any of its accounts, it would be *required by law* to pay "the full value thereof, as determined by the board of directors," which would certainly *include* the account holder's pro rata interest in Citizens' assets (J.A. 42). "In practice," Citizens Federal has never called any accounts for redemption and would, obviously, be subject to the securities laws if it did so unfairly. *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

is much more that of debtor-creditor than investment.'" *Id.* at 344. On the other hand, bank deposits, precisely because they *do* represent a debtor-creditor relationship, and *not* an investment in the enterprise, have been held by this Court *not* to constitute "securities" within the meaning of the Securities Exchange Act. *Marine Bank v. Weaver*, 455 U.S. 551, 557 (1982) (Burger, C.J.) (distinguishing *Tcherepnin* because "[i]n short, the withdrawable capital shares in *Tcherepnin* were much more like ordinary shares of stock and 'the ordinary concept of a security' . . . than a certificate of deposit [in a bank]."[12]

III

RESPONDENT'S "ALTERNATIVE" ARGUMENT IS AN ASSERTION THAT A REORGANIZATION CAN OCCUR WITHOUT CONTINUITY OF PROPRIETARY INTEREST.

Respondent contends, in the alternative, that if a reorganization took place, petitioners' exchange should still be taxed as property other than stock under section 356 of the Code (Resp. Br. 36 *et seq.*). Yet in his response to our Petition for Certiorari in this case, respondent conceded that "[p]arallel consequences for the corporation and its

[12]In *Porter v. Aetna Casualty and Surety Co.*, 370 U.S. 159 (1962), this Court also recognized that, "[u]nder the law the depositor [in a federal mutual savings and loan association] is a shareholder rather than a creditor. . . ." *Id.* at 161. As Mr. Justice Douglas stated in his separate opinion, "[t]he owner of a share account is a voting member of the association which, as the Court of Appeals noted, makes him 'more nearly comparable to a stockholder of a bank than one of its depositors'." *Id.* at 163. The issue before the Court in *Society of Savings v. Bowers*, 349 U.S. 143 (1955), on which the court of appeals below relied, did not turn on the "legal character" of accounts in mutual savings and loan associations. The Court there was concerned only with whether an Ohio state tax was, in reality, being imposed on two "mutual savings banks," or on their depositors. *Id.* at 148.

shareholders flow automatically from [the] determination" of "whether the merger was a tax-free 'reorganization'" (Resp. Pet. Br. 7, n. 2). Respondent further conceded that the court of appeals decision below therefore "squarely conflicts with the decisions of the Court of Claims in *Capital Savings & Loan*, . . . the Sixth Circuit in *West Side Federal Savings & Loan*, . . . and the Tenth Circuit in *Everett*. . . ." (*Id.* at 7), which each found a comparable merger to be a reorganization at the corporate level. Similarly, in his brief to the Court of Claims in *Capital Savings & Loan Ass'n v. United States*, 607 F.2d 970 (Ct. Cl. 1979), he contended:

> [Capital Savings & Loan Association's] suggestion . . . that the proper characterization of its merger as a reorganization might differ vis-a-vis Franklin's guaranty stockholders from what that characterization should be from its standpoint is *plain nonsense*. All aspects of the merger transaction must be evaluated and then the transaction as a whole will or will not qualify as a reorganization.

Reply Brief For the United States In Support Of Its Motion For Summary Judgment In *Capital Savings & Loan Ass'n v. United States*, at 10, n.4 (Reply Br. App. 1). The Court of Claims agreed, stating:

> We are aware that one of the ramifications of our decision is that Franklin stockholders will not have their gain, if any, recognized until they withdraw sums from their Capital accounts. . . .

607 F.2d. at 977.

Now embracing what he proclaimed to be "plain nonsense," respondent states that "[e]ven if [the Citizens Federal accounts] are imbued with sufficient equity characteristics to satisfy the 'continuity of proprietary interest' test, and thus enable the overall transaction to qualify as a

'reorganization,' . . . petitioners . . . must recognize gain [on their exchange] . . . ." (Resp. Br. 37).

It is well-settled that only stock will satisfy the continuity of proprietary interest requirement, without which there cannot be a reorganization. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) (receipt of cash and short term promissory notes); *Le Tulle v. Scofield*, 308 U.S. 415, *reh'g denied*, 309 U.S. 694 (1940) (receipt of debt securities). If the sole consideration received by the exchanging shareholders is debt, cash or other property, the transaction is nothing more than a sale, and does not "partake of the nature of a [reorganization]." 296 U.S. at 385. Moreover, as this Court instructed in *Minnesota Tea*, 296 U.S. 378, the qualifying consideration (stock) received by the exchanging shareholders must "represent a substantial part of the value of the [assets] transferred." *Id.* at 385.

Ignoring this established line of authority in his "alternative argument," respondent urges this Court to find that if there was a reorganization, petitioners and the other former Commerce stockholders must nonetheless be taxed as if they had already liquidated their accounts, or, to put it another way, as if they had received no proprietary interest in Citizens Federal in the merger.[13] If that were the case, the transaction *would* be nothing more than a sale for *all concerned*. Respondent is therefore contending that there can be a reorganization without any continuing proprietary interest on the part of the exchanging shareholders. He acknowledges this when he confesses that his "reasoning also suggests that the value of the 'equity components' of petitioners' savings accounts is close to zero,"

[13]Obviously, petitioners, no more than any other shareholder, can both dispose of their shares and also retain their ownership rights in Citizens.

and adds that it "merely goes to show that [his] primary submission is correct" (Resp. Br. 41-42). In substance, then, respondent's alternative position, for which he cites no precedent, would require that the Court overrule *Pinellas*, *Le Tulle v. Scofield* and *Minnesota Tea*, and thus upset fifty years of tax jurisprudence.

IV

RESPONDENT'S SO-CALLED "SERIOUS PRACTICAL AND ADMINISTRATIVE PROBLEMS" ARE THE SAME HERE AS WITH ANY REORGANIZATION.

Respondent again raises the specter of collection difficulties unless mergers such as this are denied reorganization treatment. Aside from being irrelevant to whether the merger at issue was a reorganization, the collection difficulty described by respondent is present in any reorganization. Because gain is deferred on the transaction, the exchanging shareholders retain their old basis and thus recognize the full amount of the deferred gain, if any, when they liquidate the investment and have the money to pay the tax.

The substituted basis flowing from reorganization treatment is no more of a practical problem in this case than in any other. More often than not, exchanging shareholders receive a different number of shares, or a different kind of shares, of stock than they surrender. Basis must, therefore, always be apportioned and traced so that gain can be properly reported when the stock is redeemed or sold.

As we noted in our Opening Brief, in all of the mergers of this type we have seen, the accounts received by the exchanging shareholders have been segregated and the passbooks or certificates stamped to reflect that they represented exchange accounts. No additional sums are invested in the exchange accounts. If the owners wish to increase their investment in the association, they are free to open another, separate account. Thus, respondent's assertion

that "[e]very time petitioners deposited money into their passbook savings accounts, they would have to keep the 'new cash' . . . separate from the 'old cash' . . ." (Resp. Br. 42) is simply a red herring. Nor are withdrawals a problem. Basis is easily allocated to the portion withdrawn and gain reported on the difference between the allocated basis and the amount of cash received.[14]

Finally, respondent claims, on the one hand, that if petitioners' accounts are "stock," section 302 of the Code would require that each redemption be tested to determine whether it was "essentially equivalent to a dividend," and on the other hand, that section 302 does not apply (Resp. Br. 22-23, 43). Petitioners reiterate that section 302 *does* apply to shareholders in mutual savings and loan associations, but because withdrawals are normally non-pro rata and sporadic, they are not "essentially equivalent to a dividend" and therefore are treated as "exchanges" under section 302(b)(1) (Pet. Br. 41).

V

CONCLUSION

The judgment of the court of appeals should be reversed.

Dated: October 19, 1984.

Respectfully submitted,

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[14]Respondent's allusion to "checking accounts" (Resp. Br. 43) which federal associations have been allowed to offer since Congress passed new legislation in 1982 is inapposite. That was not the law at the time of this merger, and petitioners' share accounts are not checking accounts. *See* Thrift Institutions Restructuring Act of 1982, Pub. L. No. 97-320, § 301, 96 Stat. 1469.

APPENDIX.

12 C.F.R. § 541.3 (1976 ed.):

§ 541.3 Capital.

The term "capital" means in a Federal mutual association the aggregate of the payments on savings accounts plus earnings credited thereto less lawful deductions therefrom.

12 C.F.R. § 541.4 (1976 ed.):

§ 541.4 Savings Account.

The term "savings account" means the monetary interest of the holder thereof in the capital of a Federal mutual association and consists of the withdrawal value of such interest.

Footnote 4 From "Reply Brief For The United States In Support Of Its Motion For Summary Judgment And Brief In Opposition To Plaintiff's Motion For Summary Judgment" in *Capital Savings & Loan Association v. United States*, 607 F.2d 970 (Ct. Cl. 1979):

Taxpayer's suggestion (Br. 33) that the proper characterization of its merger as a reorganization might differ vis-a-vis Franklin's guaranty stockholders from what that characterization should be from its standpoint is plain nonsense. All aspects of the merger transaction must be evaluated and then the transaction as a whole will or will not qualify as a reorganization. If, as we contend, the equity interest in Franklin (the guaranty stock) was exchanged for the equivalent of debt (Capital savings accounts), then the merger obviously does not qualify as a reorganization at any level or for any purpose.

INTERNAL REVENUE CODE OF 1954 (26 U.S.C.):
Sec. 593. RESERVES FOR LOSSES ON LOANS.

• • • • •

(e)(2) AMOUNTS CHARGED TO RESERVE ACCOUNTS AND INCLUDED IN GROSS INCOME. — If any distribution is treated under paragraph (1) as having been made out of the reserves described in subparagraphs (B) and (C) of such paragraph, the amount charged against such reserve shall be the amount which, when reduced by the amount of tax imposed under this chapter and attributable to the inclusion of such amount in gross income, is equal to the amount of such distribution; and the amount so charged against such reserve shall be included in gross income of the taxpayer.

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